

**DATE:** August 14, 2009

**MEMORANDUM TO:** Board of Directors

**FROM:** Sandra L. Thompson  
Director

**SUBJECT:** Notice of Proposed Rulemaking regarding *Risk-Based Capital Guidelines: Impact of Modifications to Generally Accepted Accounting Principles; Consolidation of Asset-Backed Commercial Paper Programs; and Other Related Issues*

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**Proposal:** That the Board of Directors (Board) of the Federal Deposit Insurance Corporation (FDIC) approve publication of the attached Notice of Proposed Rulemaking (NPR), *Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Regulatory Capital; Impact of Modifications to Generally Accepted Accounting Principles; Consolidation of Asset-Backed Commercial Paper Programs; and Other Related Issues*. If approved, the NPR would be published in the *Federal Register* on an interagency basis by the FDIC, the Board of Governors of the Federal Reserve System (FRB), the Office of Thrift Supervision (OTS), and the Office of the Comptroller of the Currency (OCC) (together, the Agencies) for a 30-day public comment period.

The NPR seeks comment on a proposal to amend the Agencies' general risk-based capital standards and the advanced risk-based capital adequacy framework (together, the risk-based capital rules) in recognition of the regulatory capital impact of two recently-issued accounting standards from the Financial Accounting Standard Board (FASB): Statement of Financial Accounting Standards No. 166, *Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140* (FAS 166), and Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)* (FAS 167). Specifically, the NPR proposes to amend the risk-based capital rules to (i) eliminate the exclusion of certain consolidated asset-backed commercial paper (ABCP) program assets from risk-weighted assets and (ii) provide a reservation of authority to permit the Agencies to require banks to treat structures that are not consolidated under the accounting standards as if they were consolidated for risk-based capital purposes, commensurate with the risk relationship of the bank to the structure.

A preliminary analysis indicates that the implementation of FAS 166 and FAS 167 will increase the amount of assets and liabilities reported on some banks' balance sheets and, for some banks, result in significantly higher regulatory capital requirements. In light of this, the NPR requests comment on the appropriateness of a phase-in of the increase in banks' capital requirements that would result from the implementation of these accounting standards. The NPR also requests comment on various matters involving the effect of FAS 166 and FAS 167 on securitizations and related activities by banks and any accounting treatment and risk-based capital requirements involving those activities.

**Recommendation:** That the Board approve publication of this NPR for a public comment period of 30 days.

Concur:

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Michael Bradfield  
General Counsel

## Background

Under generally accepted accounting principles (GAAP), the treatment for structured finance transactions involving a special purpose entity (SPE) has been governed by the requirements of Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140), and FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities* (FIN 46(R)). Under FAS 140 (which is in effect through the end of 2009), when certain conditions are met, transfers of assets by a bank to an entity that meets the definition of a qualifying special purpose entity (QSPE) are recognized as sales, which permits the bank to remove the assets from its balance sheet. In addition, FIN 46(R) specifically excludes QSPEs from its scope despite the fact that many QSPEs would have otherwise been deemed variable interest entities (VIEs) subject to possible consolidation.<sup>1</sup> The consolidation requirements of FAS 140 and FIN 46(R) have permitted a number of banks to recognize securitized assets as off-balance exposures, which generally receive more favorable treatment for regulatory capital purposes. At the same time, however, banks have retained significant potential exposure to these assets in the form of non-contractual or implicit recourse.

On June 12, 2009, FASB finalized modifications to FAS 140 and FIN 46(R) through FAS 166 and FAS 167, which are effective for the first annual reporting period that begins after November 15, 2009, for interim periods therein, and for interim and annual periods thereafter. Among other things, FAS 166 and FAS 167 remove the concept of a QSPE from GAAP and alter the consolidation analysis for VIEs, thereby requiring banks to consolidate many VIEs that are not consolidated under current GAAP standards.

As a result of the implementation of FAS 166 and FAS 167, the categories of securitization and structured finance exposures that are currently off-balance sheet that are likely to be subject to consolidation on the balance sheet of the originating or servicing bank include: ABCP conduits; loan securitizations in which a bank retains a residual interest and servicing rights, including some student loan and automobile loan securitizations; revolving securitizations structured as

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<sup>1</sup> For these reasons, banks typically establish a “qualifying special purpose entity” (QSPE) for their securitizations. Thus, the assets and liabilities in most bank securitizations are currently off-balance sheet.

master trusts; and certain tender option bond trusts that were designed as QSPEs. Thus, the implementation of FAS 166 and FAS 167 will for some banks increase the amount of assets and liabilities reported on their balance sheets and, for some banks, result in significantly higher regulatory capital requirements.

## **Proposal**

In view of the GAAP modifications resulting from the implementation of FAS 166 and FAS 167, and the interaction of such modifications with the regulatory capital requirements, the Agencies' staffs believe that the modified consolidation analysis of FAS 167, as well as enhanced requirements for recognizing transfers of financial assets under FAS 166, converge in many respects with the Agencies' assessment of a bank's risk exposure to structured finance and other transactions subject to FAS 166 and FAS 167. As the recent turmoil in the financial markets has demonstrated, many banks are willing to provide credit support to off-balance sheet entities that they sponsor even though they are not required contractually to do so. For example, recent performance data on revolving securitizations of credit card receivables show that banks have often provided non-contractual (implicit) support to prevent downgrades of senior securities, thereby mitigating reputational risk and preserving access to cost-effective funding.

In light of this recent experience, the Agencies' staffs believe that the broader accounting consolidation requirements implemented by FAS 166 and FAS 167 will result in a regulatory capital treatment that more appropriately reflects the risks to which banks are exposed. Additionally, FAS 166 and FAS 167 require a bank to regularly update its consolidation analysis with respect to VIEs, and recognize enhanced requirements for recognition of asset transfers and ongoing disclosure requirements for financial assets with which the bank maintains some continuing involvement. These requirements are consistent with the view that the capital treatment for some previously unconsolidated VIEs does not reflect the actual risk to which the bank may be exposed.

Consistent with FAS 166 and FAS 167, the NPR proposes to eliminate existing provisions in the risk-based capital rules that permit a bank that is required to consolidate an ABCP program

under GAAP to exclude the consolidated ABCP program assets from risk-weighted assets and instead assess the risk-based capital requirement against any contractual exposures of the organization arising from the ABCP program. The NPR also proposes revisions to the reservations of authority provided in the risk-based capital rules that would permit the Agencies to require banks to treat structures that are not consolidated under GAAP as if they were consolidated for risk-based capital purposes, commensurate with the risk relationship of the bank to the structure.

The NPR requests public comment on the regulatory capital impact of FAS 166 and FAS 167, including, with respect to the types of VIEs a bank will have to consolidate, the features and characteristics of securitization transactions or other transactions with VIEs and other special purpose entities that are more or less likely to cause a bank to provide implicit support, and the effect of FAS 166 and FAS 167 on a bank's financial position, lending, and activities.

In addition, as an option to the proposal, the NPR presents a framework that would provide an incremental phase-in of the increase in banks' capital requirements resulting from the implementation of FAS 166 and 167, and solicits comment whether the agencies should consider such a phase-in for purposes of any final rule. Finally, the NPR requests comment on whether securitized loans that remain on the balance sheet should be made subject to the same loan loss provisioning process, including historical loss rates adjusted for current conditions that is applied to similar loans that are not securitized, as well as comment on the impact of FAS 166 and FAS 167 on federal regulatory reform initiatives involving the securitization markets (such as, "skin in the game" proposals), and the consolidation analysis for servicers participating in the US Treasury's Making Home Affordable Program.

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