Final Rule Amending the Risk-Based Capital Rules
to Reflect the Issuance of FAS 166 and FAS 167

Summary

This Final Rule amends the agencies' general risk-based and advanced risk-based capital adequacy frameworks 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).

The Final Rule permits a banking organization to delay and phase-in the implementation of FAS 167 for purposes of the Agencies' risk-based capital requirements (the transition mechanism). Specifically, the Final Rule provides for an optional two-quarter implementation delay. This is then followed by an optional two-quarter partial implementation of the effect on risk-weighted assets that will result from changes to U.S. generally accepted accounting principles (GAAP) from FAS 166 and FAS 167. Additionally, for the first two quarters following the implementation date of FAS 166 and FAS 167, the Final Rule permits banking organizations to include without limit in tier 2 capital any increase in the allowance for loan and lease losses (ALLL) calculated as of the implementation date that is attributable to assets consolidated under the requirements of FAS 167. This is followed by an optional two-quarter phase-in of the regulatory restriction on the amount of such ALLL that may be included in tier 2 capital. The transition mechanism will apply only to the Agencies' risk-based capital requirements, and not to the leverage capital ratio.

In addition, the Final Rule eliminates the exclusion of certain consolidated asset-backed commercial paper (ABCP) programs from risk-weighted assets and provides a reservation of authority to permit the Agencies to require banking organizations to treat entities that are not consolidated under GAAP as if they were consolidated for risk-based capital purposes, commensurate with the risk relationship of the banking organization to the entity.

Background

Under 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. 46(R), *Consolidation of Variable Interest Entities* (FIN 46(R)). Under FAS 140, 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 permit 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 VIEs subject to possible consolidation.

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. 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 GAAP.

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; revolving securitizations structured as 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 may result in significantly higher regulatory capital requirements.

Final Rule

The Final Rule provides an optional transition mechanism to delay and phase in the impact of FAS 167 on risk-weighted assets. However, the transition mechanism will not apply to the leverage capital ratio. Under the transition mechanism, a banking organization may elect to delay the impact of FAS 167 on risk-weighted assets for the first two quarters after the date it implements FAS 166 and FAS 167. Thereafter, a banking organization that opted for the delay may elect to phase in the risk-based capital requirements resulting from the implementation of FAS 167 over the third and fourth quarters after the implementation date. However, a bank electing the transition mechanism may not exclude from risk-weighted assets the assets of a VIE to which it has provided implicit support. For example, a bank with an annual reporting period beginning on January 1, 2010, could choose to exclude from its risk-weighted assets for the first two quarters of 2010 those assets held by VIEs that must be consolidated as a result of implementing FAS 167, provided that the VIEs existed and had not been consolidated prior to the implementation date. For the third and fourth quarters of 2010, the bank may exclude from risk-weighted assets 50 percent of the amount of risk-weighted assets associated with the VIEs subject to exclusion as of the implementation date of FAS 166 and FAS 167. However, during these four quarters, the bank may not include in risk-weighted assets an amount less than the aggregate risk-weighted assets it held based on its contractual exposures to these VIEs as of the implementation date of FAS 166 and FAS 167, had the VIEs not been consolidated.

Under the general risk-based capital rules, the amount of the ALLL that may be included in tier 2 capital is restricted to 1.25 percent of total risk-weighted assets. For the first two quarters following the implementation date of FAS 166 and FAS 167, the Final Rule permits a banking organization to include without limit in tier 2 capital the full amount of the ALLL calculated as of the implementation date that is attributable to the assets that have been consolidated on the banking organization's balance sheet, but have been excluded pursuant to the transition mechanism for risk-weighted assets (inclusion amount). For the third and fourth quarters after the implementation date of FAS 166 and 167, a banking organization that elects the transition mechanism for risk-weighted assets during these quarters may include in tier 2 capital without limit 50 percent of the inclusion amount. During the four quarters after the implementation of FAS 166 and 167 and thereafter, a banking organization must count toward the 1.25 percent tier

2 capital limit all of the ALLL that is associated with the assets of a VIE to which it has provided implicit support.

The Final Rule eliminates existing provisions in the risk-based capital rules that permit a banking organization to exclude from risk-weighted assets the assets of an ABCP program that the banking organization is required to consolidate under GAAP and for which the banking organization acts as sponsor (the ABCP exclusion).

The Final Rule includes a new reservation of authority for the risk-based capital rules specifying that a banking organization's primary Federal supervisor would have the authority to require the banking organization to treat an off-balance sheet entity as if it were consolidated onto the banking organization's balance sheet and to hold capital against the entity's exposures for risk-based capital purposes, commensurate with the actual risk relationship of the banking organization to the entity.