FDIC

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Financial Institution Letter
FIL-104-2005
October 20, 2005

RISK-BASED CAPITAL RULES

Advance Notice of Proposed Rulemaking on Modifications to the Risk-Based Capital Framework

Summary: The federal bank and thrift regulatory agencies have jointly issued the attached advance notice of proposed rulemaking (ANPR) on possible modifications to the risk-based capital standards for all domestic banks, bank holding companies and savings associations. The agencies are seeking public comment on the proposal. The FDIC will accept comments through January 18, 2006.

Distribution:
FDIC-Supervised Banks (Commercial and Savings)

Suggested Routing:
Chief Executive Officer
Chief Financial Officer
Chief Accounting Officer

Related Topics:
Risk-Based Capital Rules
12 CFR Part 325
Basel II

Attachments:

- Chart 1, "QIS 4 Preliminary Change in Minimum Capital Requirements of 26 Participating Institutions: Basel I to Basel II"

- Joint Advance Notice of Proposed Rulemaking, Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications

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Highlights:

The modifications under consideration in the ANPR are intended to:

- Modernize the risk-based capital rules to ensure that the capital framework remains a relevant and reliable measure of risks present in the banking system.

- Minimize potentially material differences in capital requirements that may arise between banks that adopt Basel II and banks that remain under the existing risk-based capital rules.

- Maintain an operationally feasible capital framework that is relatively simple to implement for banking organizations subject to the existing risk-based capital rules.

The modifications are designed to use currently available data to implement any required changes, with the intention of minimizing the burden associated with compliance.

As required under section 2222 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA), the ANPR also solicits comments on any outdated, unnecessary or unduly burdensome requirements in the regulatory capital rules.

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MODIFICATIONS TO THE RISK-BASED CAPITAL REGULATIONS
Advance Notice of Proposed Rulemaking

The Board of Directors of the Federal Deposit Insurance Corporation (FDIC) approved the publication of an Advance Notice of Proposed Rulemaking (ANPR) on October 6, 2005, that considers a range of approaches for enhancing the risk sensitivity of the current risk-based capital framework. The ANPR is being 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 (the agencies) for a 90-day comment period. Comments are due by January 18, 2005.

The proposals under consideration could affect virtually all FDIC-supervised institutions. Institutions should closely review the attached document, which includes various alternatives to the current rules, and provide specific comments that will enable the agencies to advance fully developed proposals in a future rulemaking.

The agencies have developed high-level principles that define the objectives of the domestic capital rulemaking. These principles are:

- Address potential competitive inequities between the existing risk-based capital framework and the proposed domestic implementation of the risk-based capital framework described in "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (Basel II);[1]

- Modernize the risk-based capital rules to recognize advances made within the banking industry in the areas of credit risk measurement and mitigation; and

- Ensure that the revised framework is well suited for the approximately 9,000 banking organizations of varying asset sizes and capital levels without creating undue burden.

Addressing Potential Competitive Inequities. The FDIC recognizes the concerns raised by several institutions and trade groups regarding the potential competitive inequities that could arise between banks that adopt a Basel II framework and those that remain on the existing risk-based capital framework. Institutions are urged to analyze and compare the proposals set forth in the ANPR with the Basel II approaches currently under consideration for implementation in the United States, which are the advanced

[1] 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).

internal ratings-based approach for credit risk and the advanced measurement approach for operational risk.

To facilitate comment on the competitive aspects of these two capital frameworks, the FDIC has included in this letter selected results of the fourth quantitative impact study of Basel II (QIS-4) conducted by 26 large U.S. banking organizations. The QIS-4 results provide some perspective on the possible competitive issues that could arise between Basel II banks and those banks that will remain subject to the existing risk-based capital rules (see Chart 1). The QIS-4 results suggest that risk-based capital requirements for all major lending categories, except credit cards, would be substantially less than current requirements and possibly the requirements discussed in this ANPR.

The ANPR proposes modifications to the existing risk-based capital rules where quantitative factors used to measure the risk associated with a given product or exposure can be readily articulated. However, in certain areas the ANPR may not adequately address potential competitive inequities, especially where risk-measurement factors are not well defined or universally applied, such as with unrated commercial loans and certain retail loans. The FDIC encourages comments in those areas.

Modernizing the Risk-Based Capital Rules. The agencies seek to advance the goal of promoting greater risk sensitivity without imposing undue burden and have identified the following areas for potential modification:

- Increasing the number of risk-weight categories to which credit exposures may be assigned;
- 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 may qualify an exposure for a lower risk weight;
- 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 a 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 reflect the risks in securitizations backed by revolving retail exposures with early amortization provisions.

Ensuring the Revised Risk-Based Capital Framework Is Well Suited for All Applicable Banks. The FDIC recognizes that the proposals under consideration might not be suitable to the entire universe of institutions that will most likely not adopt the Basel II approaches. Institutions vary considerably in size and capital levels. Some institutions may be more inclined to remain on the existing risk-based capital framework rather than adopt a more risk-sensitive framework.

The FDIC encourages all commenters to carefully consider the implications of the proposals included in the ANPR. In addition to comments on the specific proposals set forth in the ANPR, the FDIC welcomes any alternatives or suggestions that would facilitate the development of fuller and more comprehensive proposals applicable to a range of activities and exposures. Finally, as required under section 2222 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA), the ANPR solicits comments on any outdated, unnecessary, or unduly burdensome requirements in the regulatory capital rules.

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Chart 1

QIS 4 Preliminary Change in Minimum Capital Requirements
of 26 Participating Institutions: Basel I to Basel II

Portfolio	% Change in Portfolio MRC (1)	Median % Change in Port. MRC (2)	Share of Basel I MRC	Share of Basel II MRC
Wholesale Credit	**(24.6%)**	**(24.5%)**	**44.3%**	**38.2%**
Corporate, Bank, Sovereign	(21.9%)	(29.7%)	33.9%	30.3%
Small Business	(26.6%)	(27.1%)	4.6%	3.9%
High Volatility CRE	(33.4%)	(23.2%)	1.8%	1.3%
Incoming Producing RE (3)	(41.4%)	(52.5%)	4.0%	2.7%
Retail Credit	**(25.6%)**	**(49.8%)**	**30.6%**	**26.0%**
Home Equity (HELOC)	(74.3%)	(78.6%)	6.1%	1.8%
Residential Mortgage	(61.4%)	(72.7%)	11.1%	4.9%
Credit Card (QRE)	66.0%	62.8%	6.1%	11.6%
Other Consumer	(6.5%)	(35.2%)	6.0%	6.4%
Retail Business Exposures	(5.8%)	(29.2%)	1.2%	1.3%
Equity	6.6%	(24.4%)	1.3%	1.6%
Other assets	(11.7%)	(3.2%)	10.0%	10.1%
Securitization	(17.9%)	(39.7%)	8.1%	7.6%
Operational Risk			**0.0%**	**10.5%**
Trading Book	0.0%	0.0%	5.2%	5.9%
Portfolio Total	**(12.5%)**	**(23.8%)**	**100.0%**	**100.0%**
Change in Effective MRC* (4)	**(15.5%)**	**(26.3%)**		

(1) <u>MRC</u> is "minimum regulatory capital" and refers specifically to risk-based capital requirements.
(2) <u>% Change in Portfolio MRC</u> is in total dollars: for example, risk-based capital changes for Corporate, Bank, and Sovereign exposures were estimated to decline by 22 percent in aggregate. The median change in this example was 30 percent, meaning 13 of the 26 organizations reported reductions in risk-based capital for this category in excess of 30%.
(3) <u>Income Producing RE</u> primarily consists of multifamily and certain types of commercial real estate loans.
(4) <u>Change in Effective MRC</u> reflects adjustments and shortfalls in reserves as defined in the Basel II framework.