Proposed Rulemakings for an Integrated Regulatory Capital Framework
Questions and Answers
June 7, 2012

Question 1: What does the package of proposed rulemakings contain and why is it divided into three parts?

- The package contains three notices of proposed rulemaking (NPRs) that, taken together, would restructure the Board's current regulatory capital rules into a harmonized, comprehensive framework, and would revise the capital requirements to make them consistent with the Basel III capital standards established by the Basel Committee on Banking Supervision (BCBS) and certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The proposals are published in separate NPRs to reflect the distinct objectives of each proposal, to allow interested parties to better understand the various aspects of the overall capital framework, including which aspects of the rule would apply to which banking organizations, and to help interested parties better focus their comments on areas of particular interest. The BCBS quantitative liquidity requirements and the BCBS capital surcharge for global systemically important banks are not part of this rulemaking.

<u>*The Basel III NPR*</u>

- The first NPR, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action* (Basel III NPR), is primarily focused on proposed reforms that would improve the overall quality and quantity of banking organizations' capital. The NPR would revise the Board's risk-based and leverage capital requirements, consistent with the Dodd-Frank Act and with agreements reached by the BCBS in *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (Basel III). The proposal includes transition provisions designed to provide sufficient time for banking organizations to meet the new capital standards while supporting lending to the economy.

<u>*The Standardized Approach NPR*</u>

- The second NPR, *Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements* (Standardized Approach NPR), would revise and harmonize the Board's rules for calculating risk-weighted assets to enhance their risk sensitivity and address weaknesses identified over recent years. It would incorporate aspects of the BCBS's Basel II standardized framework in the *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (Basel II), Basel III, and alternatives to credit ratings for the treatment of certain exposures, consistent with the Dodd-Frank Act.

<u>*The Advanced Approaches and Market Risk NPR*</u>

- The third NPR, *Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule* (Advanced Approaches and Market Risk NPR), would revise the advanced approaches risk-based capital rule (in a manner consistent with the

Dodd-Frank Act) and incorporate certain aspects of Basel III that the Board would apply only to advanced approaches banking organizations (generally, the largest, most complex banking organizations). This NPR would also codify the Board's market risk capital rule and, in combination with the other components described above, would apply consolidated capital requirements to savings and loan holding companies (SLHCs).

Question 2: Which banking organizations are covered by the proposed rulemakings?

- The Basel III NPR and the Standardized Approach NPR would apply to state member banks, bank holding companies domiciled in the United States not subject to the Board's Small Bank Holding Company Policy Statement (generally, bank holding companies with less than $500 million in consolidated assets), and SLHCs domiciled in the United States. Consistent with Section 171 of the Dodd- Frank Act, the proposed rulemakings would apply to all SLHCs regardless of asset size.

- The Advanced Approaches and Market Risk NPR would generally apply to banking organizations meeting specified thresholds. In general, the advanced approaches risk-based capital rule applies to those banking organizations with consolidated total assets of at least $250 billion or consolidated total on-balance sheet foreign exposures of at least $10 billion (excluding insurance underwriting assets) and their depository institution subsidiaries. The market risk capital rule generally applies to those banking organizations with aggregate trading assets and trading liabilities equal to at least 10 percent of quarter-end total assets or $1 billion.

Question 3: How are these proposed rulemakings related to the Dodd-Frank Act?

- The NPRs are consistent with statutory requirements in the Dodd-Frank Act. For example, pursuant to section 171 of the Act, the NPRs would establish minimum risk-based and leverage capital requirements for SLHCs, phase out certain capital instruments over a three-year period, and establish new minimum generally applicable capital requirements. In addition, pursuant to section 939A of the act, the NPRs remove references to, or requirements of reliance on, credit ratings in the Board's capital rules and replace them with alternative standards of creditworthiness.

Question 4: What are the main changes to the minimum capital requirements?

- The proposal includes a new common equity tier 1 minimum capital requirement of 4.5 percent of risk-weighted assets and a common equity tier 1 capital conservation buffer of 2.5 percent of risk-weighted assets. The proposal also increases the minimum tier 1 capital requirement from 4 to 6 percent of risk-weighted assets. The minimum total risk-based capital requirement would remain unchanged at 8 percent.

- The proposal introduces a supplementary leverage ratio that incorporates a broader set of exposures in the denominator measure of the ratio for banking organizations subject to the advanced approaches capital rule. This supplementary leverage ratio is based on the international leverage ratio in Basel III.

Question 5: What are the main changes related to the definition of capital being proposed?

- Capital instruments issued by banking organizations would be subject to a set of strict eligibility criteria that would prohibit, for example, the inclusion in tier 1 capital of instruments that are not perpetual or that permit the accumulation of unpaid dividends or interest. Trust preferred securities, for example, would be excluded from tier 1 capital, consistent with both Basel III and the Dodd-Frank Act.

- Under the Basel III NPR, banking organizations would be subject to generally stricter regulatory capital deductions (the majority of which would be taken from common equity tier 1 capital). For example, deductions related to mortgage servicing assets, deferred tax assets, and certain investments in the capital of unconsolidated financial institutions would generally be more stringent than those under the current rules.

Question 6: What is the capital conservation buffer and how would it work?

- In order to avoid limitations on capital distributions (including dividend payments, discretionary payments on tier 1 instruments, and share buybacks) and certain discretionary bonus payments, under the proposal banking organizations would need to hold a specific amount of common equity tier 1 capital in excess of their minimum risk-based capital ratios. The fully phased-in buffer amount would be equal to 2.5 percent of risk-weighted assets.

Question 7: Will the new capital requirements and capital conservation buffer be imposed immediately or will there be a transition period?

- The Basel III NPR contains transition provisions designed to give ample time to adjust to the new capital requirements, consistent with the agreement in Basel.

- The new minimum regulatory capital ratios and changes to the calculation of risk-weighted assets would be fully implemented January 1, 2015. The capital conservation buffer framework would phase-in between 2016 and 2018, with full implementation January 1, 2019.

Question 8: What is common equity tier 1 capital and why are you proposing a new common equity tier 1 requirement?

- Common equity tier 1 capital is a new regulatory capital component that is predominantly made up of retained earnings and common stock instruments (that comply with a series of strict eligibility criteria), net of treasury stock, and net of a series of regulatory capital deductions and adjustments. Common equity tier 1 capital may also include limited amounts of common stock issued by consolidated subsidiaries to third parties (minority interest). Common equity tier 1 capital is the highest quality form of regulatory capital because of its superior ability to absorb losses in times of market and economic stress.

Question 9: What are the main elements of the Standardized Approach NPR?

- It would increase the risk sensitivity of the Board's general risk-based capital requirements for determining risk-weighted assets (that is, the calculation of the denominator of a banking organization's risk-based capital ratios) by proposing revised methodologies for determining risk-weighted assets for:
  - Residential mortgage exposures by applying a more risk-sensitive treatment that would risk-weight an exposure based on certain loan characteristics and its loan-to-value ratio;
  - Certain commercial real estate credit facilities that finance the acquisition, development, or construction of real property by assigning a higher risk weight;
  - Exposures that are more than 90 days past due or on nonaccrual (excluding sovereign and residential mortgage exposures) by assigning a higher risk weight; and
  - Exposures to foreign sovereigns, foreign banks, and foreign public sector entities by basing the risk weight for each exposure type on the country risk classification of the sovereign entity.

- The NPR would also replace the use of credit ratings for securitization exposures with a formula-based approach.

- Additionally, the NPR would provide greater recognition of collateral and guarantees.

- However, for most exposures, no changes are being proposed in the NPR. More specifically, the treatment of exposures to the U.S. government, government-sponsored entities, U.S. states and municipalities, most corporations, and most consumer loans would remain unchanged.

- It would introduce disclosure requirements that would apply to banking organizations domiciled in the United States with $50 billion or more in total assets, including disclosures related to regulatory capital.

- The changes in the Standardized Approach NPR are proposed to take effect January 1, 2015. Banking organizations may choose to comply with the proposed requirements prior to that date.

Question 10: What are the primary objectives of the Advanced Approaches and Market Risk NPR?

- It would revise the advanced approaches risk-based capital rule in a manner consistent with the Dodd-Frank Act by removing references to credit ratings from the securitization framework, requiring an enhanced set of quantitative and qualitative disclosures (especially in regard to definition of capital and securitization exposures), implement a higher counterparty credit risk capital requirement to account for credit valuation adjustments, and propose capital requirements for cleared transactions with central counterparties.

- The NPR would incorporate the market risk capital rules into the integrated regulatory capital framework and propose its application to savings and loan holding companies that meet the trading thresholds.

Question 11: How will the Prompt Corrective Action (PCA) framework change as a result of the proposed rulemakings?

- Under the proposal, the capital thresholds for the different PCA categories would be updated to reflect the proposed changes to the definition of capital and the regulatory capital minimum ratios. Likewise, the proposal would augment the PCA capital categories by incorporating a common equity tier 1 capital measure. In addition, the proposal would include in the PCA framework the proposed supplementary leverage ratio for advanced approaches banking organizations. Note that the new PCA framework would take effect starting on January 1, 2015, consistent with the full transition of the minimum capital requirements and the Standardized Approach for the calculation of risk-weighted assets.