BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: July 1, 2013

To: Board of Governors

From: Staff[1]

Subject: Draft Final Regulatory Capital Rule and Market Risk Notice of Proposed Rulemaking -- Revised Memo to the Board

ACTIONS REQUESTED: Staff seeks the Board's approval of (1) the attached draft notice of final rulemaking (draft final rule) that would (i) revise and enhance the Board's general risk-based capital rules, leverage rules, and advanced approaches risk-based capital rules for state member banks and bank holding companies and prompt correction requirements for state member banks; (ii) incorporate the revised rules and the market risk capital rules for state member banks and bank holding companies (BHCs) into a new comprehensive capital framework; and (iii) apply the comprehensive capital framework to savings and loan holding companies (SLHCs) that do not have substantial insurance or commercial activities; and (2) the attached notice of proposed rulemaking (market risk NPR) that would make conforming changes to the Board's current market risk capital rule.

Staff also requests authority to make technical, non-substantive changes to the attached materials prior to publication in the *Federal Register* in order to respond to comments from the *Federal Register* or to incorporate non-substantive changes requested by other federal banking agencies as part of the approval process. The draft final rule would be issued jointly by the Board and Office of Comptroller of the Currency (OCC, and collectively with the Board, the agencies) after the agencies have completed their internal review and approval procedures.[2] The OCC expects to review and consider this as a final rule by July 9, 2013.

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[1] Messrs. Gibson, Van Der Weide, Lindo, Boemio, Climent, Geishecker, Conkling, Powell, Willis, and Healey and Mmes. Hewko, Horsley, MacDonald, Elliot, Kirkpatrick, and Phelan (Division of Banking Supervision and Regulation) and Messrs. Alvarez, McDonough, Alexander, Kress, and Buresh and Mmes. Snyder and Graham (Legal Division).

[2] The Federal Deposit Insurance Corporation (FDIC) provided notice today that it will consider this matter as an interim final rule on July 9, 2013.

INTRODUCTION: On June 12, 2012, the Board approved three joint notices of proposed rulemaking (collectively, the NPRs or the proposals) that sought public comment on proposed revisions to the agencies' capital adequacy guidelines and prompt corrective action rules.[3] The NPRs proposed to revise and enhance these requirements to implement the revised standards of the Basel Committee on Banking Supervision (BCBS), commonly called Basel III,[4] to strengthen identified areas of weakness in the capital rules, and to address relevant provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).

To address shortcomings of the international capital standards exposed during the global financial crisis, the BCBS issued revisions to these standards designed to enhance the quantity and quality of regulatory capital in the banking system, better reflect the risk of certain exposures, and build additional capacity into the banking system to absorb losses in times of future market and economic stress.[5] The Board, OCC and FDIC proposed to implement certain of these changes in the United States for all banking organizations because they would result in capital requirements that better reflect banking organizations' risk profiles and enhance the ability of banking organizations to continue functioning as financial intermediaries, particularly during stressful periods. Other proposed changes in the NPRs applied only to the largest, most complex banking organizations, commensurate with the risk profile and complexity of their activities. Together, these changes should improve the overall resilience of the banking system.

The Board received over 2,600 comment letters on the NPRs. A number of commenters criticized specific aspects of the NPRs, whereas others requested clarification on or suggested modifications to certain sections of the NPRs. Many commenters requested that the proposals not be applied to community banking organizations on the basis that: (1) community banking

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[3] The NPRs were published as joint proposed rulemakings in the Federal Register on August 30, 2012. *See* 77 *Federal Register* 52792 (August 30, 2012) (Basel NPR); 77 *Federal Register* 52888 (August 30, 2012) (Standardized NPR); 77 *Federal Register* 52978 (August 30, 2012) (Advanced Approaches NPR). The Basel NPR related to minimum capital ratios, capital buffers, and items in the numerator of the regulatory capital ratios. The Standardized NPR related to risk-weighted assets as calculated by all banking organizations. The Advanced Approaches NPR related to risk-weighted asset calculations applicable only to internationally active banking organizations and banking organizations with significant trading activities.

[4] Basel III was published in December 2010 and revised in June 2011. The text is available at http://www.bis.org/publ/bcbs189.htm.

[5] *See* http://www.bis.org/publ/bcbs189.pdf and http://www.bis.org/publ/bcbs157.pdf.

organizations have less access to the capital markets relative to larger banking organizations, requiring them to meet the new requirements solely through retained earnings, and (2) the proposals would be unnecessary and inappropriate for the business model and risk profile of community banking organizations, as Basel III was designed for large, internationally active banking organizations in response to a financial crisis attributable primarily to those institutions. These commenters requested that community banking organizations be allowed to continue to calculate their capital requirements under the current capital rules.[6] Staff has reviewed the comments on the NPRs and modified the proposal to address commenter concerns, as explained further below and as reflected in the draft final rule.[7]

DISCUSSION:

A. Scope and Timing

The draft final rule would apply to banking organizations of all sizes and types regulated by the Board and the OCC, except for bank holding companies that are subject to the Board's Small Bank Holding Company Policy Statement and SLHCs substantially engaged in insurance underwriting or commercial activities (banking organizations).[8] The application of the draft final rule to other banking organizations, regardless of size, is important to increase the resilience of the U.S. banking system by better reflecting banking organizations' risk profiles and loss absorption capacity and enhancing their ability to continue functioning as financial

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[6] The Board's existing capital requirements for state member banks are found at 12 CFR part 208, appendices A, B, E, and F, and for bank holding companies at 12 CFR part 225, appendices A, D, E, and G.

[7] *See* Appendix I for a discussion of comments received by the Board on the NPRs.

[8] The NPRs proposed consolidated capital requirements for SLHCs consistent with the transfer of supervisory responsibilities to the Board under Title III of the Dodd-Frank Act, as well as the requirements of section 171 of the Dodd-Frank Act. While section 171 contains an express exemption for BHCs subject to the Board's small bank holding company policy statement (generally those with consolidated assets of less than $500 million), it does not expressly exempt SLHCs of a similar size. Consistent with that section, the proposed rule would subject all SLHCs to the proposed capital standards, except for (1) SLHCs with more than 25 percent of their consolidated assets derived from insurance underwriting activities (other than credit insurance) and (2) grandfathered unitary SLHCs with 50 percent or more of total consolidated assets or 50 percent or more of revenues on an enterprise-wide basis derived from nonfinancial activities. This temporary exemption would allow further evaluation of appropriate consolidated capital requirements for these SLHCs.

intermediaries in times of economic stress. In response to comments about the potential burden of the proposals on smaller institutions, the draft final rule reflects changes from the proposal to address the most significant concerns about burden. For example, the draft final rule differs significantly from the NPRs with respect to risk weights for residential mortgages, unrealized gains and losses on available-for-sale securities in accumulated other comprehensive income (AOCI), and the phase out of trust preferred securities issued prior to May 19, 2010, for smaller bank holding companies and savings and loan holding companies and certain mutual holding companies.

Under the draft final rule, banking organizations that are subject to, or have elected to use, the advanced approaches rule (advanced approaches banking organizations) would be required to comply with the new capital framework starting on January 1, 2014.[9] The draft final rule would require compliance by other banking organizations and SLHCs that are not excluded from the final rule due to their insurance or commercial activities starting January 1, 2015, in order to give them additional time to comply with the draft final rule and simplify their transition to the new requirements.

B. Impact

In connection with revisions to the international capital standards, the Macroeconomic Assessment Group, a working group of the BCBS, performed a quantitative analysis and found that stronger capital requirements would lower the probability of banking crises and their associated output losses while having only a modest negative impact on gross domestic product and lending costs, and that the negative impact could be mitigated by phasing in the requirements over time.[10] Therefore, the revisions to the capital standards as incorporated into the draft final rule should benefit the financial system by reducing systemic risk, and this benefit should ultimately outweigh the burden on banking organizations of complying with the new standards.

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[9] Advanced approaches banking organizations generally are those with consolidated total assets of at least $250 billion or consolidated total on-balance sheet foreign exposures of at least $10 billion; they also include those banking organizations that have elected to use the advanced approaches rule to calculate their total risk-weighted assets. Market risk banking organizations generally are those with aggregate trading assets and trading liabilities equal to at least 10 percent of quarter-end total assets or $1 billion.

[10] *See* http://www.bis.org/publ/othp10.pdf and http://www.bis.org/publ/bcbs173.pdf.

Furthermore, pro forma analysis shows that most bank holding companies would meet the new minimum capital requirements plus the capital conservation buffer (in order to avoid restrictions on dividends and bonus payments) if the final rule were implemented today without transition provisions. For these companies, the draft final rule would help preserve and strengthen the safety and soundness and financial stability benefits of banking organizations' actions over recent years to enhance their capital adequacy. The draft final rule includes transition provisions to allow banking organizations that need additional time to meet the new thresholds to accrete capital through retained earnings; thus, most banking organizations would be able to come into compliance with the new thresholds without having to access external sources of capital.

According to Board staff pro forma analysis, more than 95 percent of bank holding companies with less than $10 billion in total assets and all bank holding companies with more than $10 billion in total assets that meet the current regulatory capital requirements would meet the 4.5 percent minimum common equity tier 1 ratio in the draft final rule. Additionally, nearly 90 percent of bank holding companies with less than $10 billion in total assets would meet the 7 percent threshold composed of the minimum common equity tier 1 ratio plus the capital conservation buffer, with an aggregate common equity shortfall of about $2 billion.

Nearly 95 percent of bank holding companies with more than $10 billion in total assets would meet the 7 percent common equity tier 1 threshold, with an aggregate short fall of approximately $2.5 billion, based on analysis that includes adjustments to the definition to capital and to risk-weighted assets under the standardized approach.

C. Revised Capital Framework

The draft final rule revises and restructures the agencies' current regulatory capital rules into a harmonized, comprehensive framework. The revised standards are consistent with the requirements of section 171 of the Dodd-Frank Act and the requirement to remove credit ratings from agency regulations under section 939A of the Dodd-Frank Act.[11] The draft final rule also

[11] *See* 12 U.S.C. 5371; note to 15 U.S.C. 78o-7. The provisions of the final rule that apply to all banking organizations establish the ''generally applicable'' capital requirements for purposes of section 171 of the Dodd-Frank Act. These include the minimum ratios established under the

makes changes to the prompt corrective action (PCA) framework for insured depository institutions by incorporating the new minimum capital ratios into the framework and aligning the definition of tangible equity for purposes of the critically undercapitalized PCA category with the definition of tier 1 capital.

The following summary highlights important aspects of the draft final rule, comments received by the Board on these aspects, and significant changes made from the NPRs. Additional detail concerning each of these matters is located in the sections identified below in the draft final rule *Federal Register* notice. The attached appendix contains a high-level summary of comments received from the public in response to the NPRs.

D. Changes Applicable to All Banking Organizations

1. Minimum regulatory capital ratio requirements (See pp. 47-62.)

Under the draft final rule, consistent with the proposals, all banking organizations would be subject to the following minimum regulatory capital requirements: a common equity tier 1 capital ratio of 4.5 percent (newly introduced requirement), a tier 1 capital ratio of 6 percent (increased from the current requirement of 4 percent), a total capital ratio of 8 percent of risk-weighted assets (unchanged from the current requirement), and a leverage ratio of 4 percent.[12] Advanced approaches banking organizations also would be subject to a minimum supplementary leverage ratio of 3 percent, based on the BCBS's international leverage ratio in Basel III. The denominator of the supplementary leverage ratio would incorporate certain off-balance sheet exposures such as commitments and derivative exposures.

Commenters expressed concerns over the increased capital requirements, noting that raising additional capital could be difficult and that holding additional capital may have significant adverse economic effects. As discussed previously, most banking organizations already meet the minimum requirements in the draft final rule. The draft final rule would help maintain banking organizations' current loss absorption capacity and resilience to economic

final rule that apply to all banking organizations, as determined using the standardized capital ratio calculations.

[12] Tier 1 capital will be equal to the sum of common equity tier 1 capital and additional tier 1 capital. Total capital will be the sum of common equity tier 1, additional tier 1, and tier 2 capital.

stress, promoting their ability to continue to lend to their communities throughout the economic cycle.

2. Capital conservation and countercyclical buffers (See pp. 62-86.)

In order to avoid restrictions on capital distributions and discretionary bonus payments to executive officers, the draft final rule would require a banking organization to hold a buffer of common equity tier 1 capital above its minimum risk-based capital requirements in an amount greater than 2.5 percent of its total risk-weighted assets (capital conservation buffer). In addition, a countercyclical capital buffer would expand the capital conservation buffer by up to 2.5 percent of a banking organization's total risk-weighted assets for advanced approaches banking organizations. The amount of the countercyclical capital buffer at any point in time would be based on national supervisors' determinations of the degree of excessive credit growth in their jurisdictions. Under the proposals, advanced approaches banking organizations would have been required to use advanced approaches risk-weighted assets in calculating the capital conservation buffer. Under the draft final rule, advanced approaches banking organizations that have completed their parallel run process would be required to calculate the capital conservation buffer using the lower of their standardized approach and advanced approaches risk-based capital ratios. This change is consistent with how advanced approaches banking organizations compute their minimum capital ratios.

Commenters asserted that the capital conservation buffer would impose an undue burden on smaller banking organizations, which generally face greater difficulty raising additional capital than larger banking organizations. Several commenters requested a full exemption from the buffer for community banking organizations. The capital conservation buffer would enhance the safety and stability of the financial system by limiting capital distributions and discretionary bonus payments as the financial condition of a banking organization weakens; it does not require a banking organization to raise additional capital to meet a minimum regulatory requirement. Moreover, as noted above, over 90 percent of bank holding companies with less than $10 billion in consolidated assets already have sufficient capital to meet the required minimum capital levels plus the capital conservation buffer. Accordingly, the benefits of applying the capital conservation buffer to all banking organizations outweigh the expected costs, and the final rule applies the capital conservation buffer, subject to transition provisions, to all banking organizations.

3. Revisions to the definition of capital (See pp. 99-205.)

Consistent with the proposals, the draft final rule would establish qualification criteria for common equity, additional tier 1, and tier 2 capital instruments that help to ensure their ability to absorb losses. These criteria are substantially the same as proposed, with some technical revisions recommended in response to comments.

The draft final rule would continue to require banking organizations with $15 billion or more in consolidated assets as of December 31, 2009, to phase non-qualifying capital instruments out of tier 1 capital by 2016, as proposed in the NPRs and consistent with section 171 of the Dodd-Frank Act. However, numerous commenters criticized the proposal to impose a 10-year phase-out period for non-qualifying capital instruments, including trust preferred securities, for banking organizations with less than $15 billion in consolidated assets as of December 31, 2009 (and companies that were mutual holding companies as of May 19, 2010). The commenters observed that section 171 of the Dodd-Frank Act required no phase out for these companies of non-qualifying capital instruments issued prior to May 19, 2010. In consideration of community banking organizations' limited access to capital markets, and as permitted by section 171 if the Dodd-Frank Act, the draft final rule would not require a phase out of non-qualifying tier 1 capital instruments issued prior to May 19, 2010, for banking organizations with less than $15 billion in assets as of December 31, 2009, or that were organized in mutual form as of May 19, 2010. (See pp. 130-131 for discussion on the treatment of trust preferred securities.)

The draft final rule would incorporate the proposed limitations on minority interest, which are consistent with Basel III and designed to ensure that banking organizations do not unduly rely on capital issued by their consolidated subsidiaries that is not available to absorb losses of the consolidated organization. (See pp. 135-140 for discussion on the treatment of minority interest.)

Under the draft final rule, regulatory capital deductions are stricter than those required under the agencies' current capital rules, with most deductions taken from common equity tier 1 capital. For example, certain deferred tax assets, mortgage servicing assets, and "significant" investments in the capital instruments of unconsolidated financial institutions are subject to deduction if they surpass an individual limit of 10 percent of common equity tier 1 capital or an aggregate limit of 15 percent.[13] Commenters requested a more lenient aggregate limit to avoid regulatory capital shortfalls resulting from the deductions, and many also argued that the proposed limits would create disincentives for banking organizations to hold mortgage servicing assets. In recognition of the stricter deductions from, and limits on, capital in the draft final rule, which may cause some banking organizations to modify their capital structure or business model, the draft final rule provides a lengthy transition period to allow banking organizations to adequately plan for such stricter deductions and limits. (See pp. 145-153 for discussion of regulatory capital deductions.)

The proposals would have required that all unrealized gains and losses in AOCI (with the exception of unrealized gains and losses on cash flow hedges relating to items that are not fair-valued on the balance sheet) be included in the common equity tier 1 capital of all banking organizations. Many commenters objected to the inclusion of these unrealized gains and losses in common equity tier 1 capital, claiming that the compliance burden would be high and that the volatility of regulatory capital would significantly increase simply as a result of fluctuations in benchmark interest rates.

In response to these comments, the draft final rule would provide banking organizations other than advanced approaches banking organizations a one-time election to opt-out of the requirement to include most AOCI components in the calculation of common equity tier 1 capital and, in effect, retain the AOCI treatment under the current capital rules. The one-time election would be made on the first regulatory reporting period under the final rule and could only be changed in very limited circumstances, in order to discourage regulatory arbitrage. This election

[13] In response to comments, the agencies modified the definition of "financial institution" to reduce operational burden and align the scope of the definition to the purpose of the deduction – to reduce interconnectedness in the financial system. *See* pp. 168-176 for a discussion of the changes to this definition.

would reduce the potential burden of the draft final rule, particularly for smaller banking organizations, which may not have the capacity to effectively manage the regulatory capital volatility associated with recognizing unrealized gains and losses. Other banking organizations that do not make such an election and all advanced approaches banking organizations would reflect most AOCI components in their common equity tier 1 capital under the final rule. (See pp. 156-167 for discussion on the treatment of AOCI)

E. Standardized Approach for Risk-weighted Assets

1. Overview

The standardized approach in the draft final rule would harmonize the banking agencies' calculation of risk-weighted assets and address shortcomings in risk-based capital requirements identified by the agencies, including during the recent financial crisis, by increasing the required capital for certain assets. In addition, the standardized approach would serve as a floor pursuant to section 171 of the Dodd-Frank Act with respect to any leverage and risk-based capital requirements that the Board may impose on bank holding companies, any nonbank financial company designated by the Financial Stability Oversight Council, savings and loan holding companies, and state member banks.[14] Higher risk weights would apply to high-volatility commercial real estate loans, past due loans, and certain securitization exposures. The standardized approach also would provide enhanced recognition of collateral and guarantees and incentives for clearing derivatives and repo-style transactions through central counterparties.

Beginning on January 1, 2015, all banking organizations would be required to calculate risk-weighted assets under the standardized approach. Until then, banking organizations other than advanced approaches banking organizations would remain subject to the general risk-based capital rules. From January 1, 2014, to December 31, 2014, advanced approaches banking organizations would be required to use the current general risk-based capital rules, including the current market risk rule, to calculate their standardized total risk-weighted assets under the draft final rule.[15]

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[14] 12 U.S.C. 5371.

[15] An advanced approaches banking organization on parallel run will use the general risk-based capital rules to calculate its risk-weighted assets for purposes of determining its risk-based

2. Calculation of risk-weighted assets (See pp. 235-409.)

Under the draft final rule, exposures to the U.S. government generally would receive a zero percent risk weight and exposures to U.S. public-sector entities (PSEs), U.S. government-sponsored entities (GSEs), and U.S. depository institutions generally receive a 20 percent risk weight, unchanged from the general risk-based capital rules.[16]

The agencies proposed to use the Organization for Economic Co-operation and Development's (OECD) country risk classifications (CRCs) to assign risk weights to exposures to sovereign entities. The risk weight for an exposure to a foreign bank or PSE, such as a state or municipality, would have been assigned based on the CRC rating of its home country.

After the NPRs were issued, the OECD determined to cease rating certain high-income jurisdictions, making the proposed use of CRC ratings inoperable in those instances. As a result, the draft final rule instead provides that OECD member countries without a CRC rating will receive a risk weight of zero while non-member countries without a CRC rating will receive a risk weight of 100 percent. Sovereign exposures to countries with a CRC rating will continue to be assigned the risk weight that corresponds to the CRC ratings, as proposed in the NPRs. Additionally, a sovereign exposure would receive a risk weight of 150 percent if such sovereign has experienced an event of default within the last five years. Where applicable, the CRC ratings are a reasonable alternative to credit ratings for sovereign exposures, and the CRC methodology is more granular and risk sensitive than the current risk-weighting methodology based solely on OECD membership. (See pp. 240-245 for discussion on the treatment of sovereign exposures.)

Under the proposals, residential mortgage exposures would have been assigned to a range of risk weight categories (between 35 and 200 percent) based upon the loan-to-value (LTV) ratio of the mortgage and certain mortgage product features. Many commenters objected to these

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capital ratios. It will report its calculation of advanced approaches risk-weighted assets to its primary federal supervisor on a confidential basis.

[16] Exposures conditionally guaranteed by the U.S. government and its agencies generally receive a 20 percent risk weight.

proposed risk weights as punitive for certain loan products that performed well in the crisis and overly conservative relative to the risk weights assigned to other exposures. Many commenters also asserted that the proposed risk-weighting framework for residential mortgage exposures would have imposed significant compliance burden on smaller banking organizations that could push them out of the mortgage origination business.

In light of new regulations designed to improve the quality of mortgage underwriting as well as continued uncertainty regarding the aggregate impact of pending mortgage-related rulemakings, the draft final rule does not include the proposed risk weights and instead incorporates the risk weights for residential mortgages under the general risk-based capital rules, which assign a risk weight of either 50 percent (for most first-lien exposures) or 100 percent for other residential mortgage exposures. (See pp. 255-260 for discussion on the treatment of residential mortgage exposures.)

As demonstrated over several recent economic cycles, certain acquisition, development and constructions (ADC) loans present elevated risks for which banking organizations should hold additional capital. Accordingly, as proposed, the draft final rule would assign a 150 percent risk weight to high-volatility commercial real estate exposures. In response to concerns raised by commenters, the definition of ADC loans has been revised to exclude loans to facilitate certain community development projects as well as loans secured by agricultural land.

The draft final rule generally increases to 150 percent the risk weight for exposures that are more than 90 days past due or on nonaccrual. Currently, these assets are generally assigned a 100 percent risk weight. Commenters objected to the heightened risk weight for past due or nonaccrual exposures on the grounds that the risks posed by these exposures were already covered by allowances for loan and lease losses (ALLL) and that the heightened risk weight would be pro-cyclical. However, ALLL is intended to cover expected losses in the portfolio while regulatory capital is held to protect against unexpected losses. Thus, the heightened risk weight would better reflect the impaired credit quality and increased probability of unexpected losses on these exposures relative to exposures that are not significantly past due or on nonaccrual.

The draft final rule will introduce capital requirements for cleared transactions with central counterparties and for default fund contributions to central counterparties (CCPs) by clearing member banking organizations, as proposed. In general, CCPs help improve the safety and soundness of the derivative and repo-style transaction markets through the multilateral netting of exposures, establishment and enforcement of collateral requirements, and the promotion of market transparency.

The agencies' general risk-based capital rules do not require capital to be held for assets sold with representations and warranties that contain certain early default clauses or premium refund clauses that apply within 120 days of the sale. In the NPRs, the agencies proposed to remove this 120-day safe harbor due to banking organizations' exposure to credit risk during this period. Commenters objected to the removal of this treatment and expressed concern that it would be unduly burdensome, increase the cost of lending, and create confusion among market participants as to what constitutes a credit-enhancing representation and warranty. In light of these comments and to address confusion about what qualifies as a credit-enhancing representation and warranty, the draft final rule retains the current 120-day safe harbor. Additionally, the draft final rule stipulates that banking organizations apply a 20 percent credit conversion factor to all short-term commitments of one year or less that are not unconditionally cancelable, as initially proposed. (See pp. 267-279 for discussion on the treatment of off-balance sheet exposures.)

Under the draft final rule, a banking organization would determine the risk-based capital requirement for securitization exposures by applying either (1) the gross-up approach from the general risk-based capital rules based on the subordination of a securitization exposure, or (2) a simplified supervisory formula approach (SSFA), which is a simplified version of the supervisory formula approach (SFA) in the advanced approaches rule and has been adopted by the agencies in the market risk rule. The draft final rule would modify the SSFA to recognize common deferral features associated with student and consumer loans unrelated to credit risk, in response to commenter concerns. (See pp. 339-381 for discussion on the treatment of securitization exposures.)

The draft final rule includes qualitative and quantitative disclosure requirements for top-tier banking organizations with $50 billion or more in total consolidated assets that are not subject to the advanced approaches rule's disclosure requirements.

F. Advanced Approaches and Market Risk

1. Advanced approaches (See pp. 408-463.)

The draft final rule would incorporate changes to the Basel capital framework, including those related to the securitization framework, treatment of counterparty credit risk, and disclosure requirements regarding capital instruments and securitization exposures. These modifications would ensure that advanced approaches banking organizations hold more appropriate levels of capital for these exposures and would increase the amount of publicly available information on these organizations.

Public comments on this section of the proposals were minimal and generally technical in nature. In many cases, the comments received on the Standardized NPR were also relevant to the proposed changes to the Advanced Approaches NPR. The agencies generally took a consistent approach towards addressing the comments with respect to the Standardized and Advanced Approaches NPRs.

The draft final rule would include a higher counterparty credit risk capital requirement, consistent with Basel III, to account for credit valuation adjustments (CVA). CVA is the fair value adjustment that reflects counterparty credit risk in the valuation of an over-the-counter derivative contract. The capital requirement reflects the significant amount of counterparty credit risk losses due to CVA during the financial crisis. The draft final rule also would make changes to the advanced approaches' internal models methodology (IMM), requiring banking organizations to consider stressed inputs when calculating their capital requirements for counterparty credit risk.

To recognize the higher correlation of financial institutions' creditworthiness due to sensitivity to common risk factors, and consistent with Basel III, the draft final rule would increase capital requirements for exposures to non-regulated financial institutions and to regulated financial institutions with consolidated assets of greater than or equal to $100 billion.

The draft final rule removes the ratings-based and the internal assessment approaches for securitization exposures from the current advanced approaches rule. They would be replaced by the use of either the SFA or the SSFA for an advanced approaches banking organization to calculate its capital requirement for securitization exposures.

The final advanced approaches capital requirements also include requirements for cleared transactions with central counterparties and for default fund contributions parallel to those in the standardized approach, discussed above. Advanced approaches banking organizations would remain subject to enhanced disclosure requirements.

2. Market risk capital rule (See pp. 463-469.)

The draft final rule would integrate the agencies' market risk capital rule into the comprehensive capital framework and implement the market risk capital rule for certain SLHCs. Apart from the concerns expressed by some commenters regarding the applicability of the market risk capital rule to SLHCs, the agencies did not receive significant comments on the proposed market risk requirements.

G. Market Risk NPR

The market risk NPR would (1) revise the treatment under the current market risk rule of the specific risk weights for sovereign exposures, non-publicly traded mutual funds, and certain student loans that are securitized and traded, and (2) clarify the timing of disclosures required under the current market risk rule. These changes would align the treatment of these items with the treatment in the draft final rule during the transition to the new comprehensive capital framework. The market risk NPR would be issued for public comment for a period of approximately 60 days.

CONCLUSION: Staff recommends that the Board adopt the attached draft final rule and issue the attached market risk rule for comment. Staff also recommends that the Board delegate to staff the authority to make technical and minor changes to the attached materials prior to publication in the *Federal Register*, including responding to comments from the *Federal Register*, or to incorporate changes requested by other agencies as part of the approval process.

APPENDIX I

Overview of Comments on the NPRs

The Board received approximately 2,600 comment letters on the June 2012 proposals. Commenters included banking organizations, trade associations, supervisory authorities, consumer advocacy groups, pubic officials (including members of the U.S. Congress), private individuals, and other interested parties.

General comments:

While most commenters supported more robust capital standards and efforts to improve the resilience of the banking system, many commenters expressed concerns about the potential costs and burdens of various aspects of the proposals, particularly for smaller banking organizations. A substantial number of commenters requested the withdrawal of or significant revisions to the proposals. Many commenters also asked for additional time to transition to the new requirements.

Aggregate impact and costs:

A majority of the commenters expressed concern regarding the potential aggregate impact of the proposals together with other provisions of the Dodd-Frank Act. Some commenters urged the agencies to withdraw the proposals and undertake a quantitative impact study that would measure the aggregate impact of the proposals along with other recent regulatory efforts, such as the risk retention proposal and the final qualified mortgage rule, among others.

Commenters argued that the proposals would have significant negative consequences for the financial services industry and the broader economic recovery. They asserted that higher capital requirements combined with increased risk-weighting on certain asset categories would negatively affect the banking sector. The negative consequences they outlined include restricted job growth; reduced lending or higher-cost lending, including to small businesses and minorities; limited availability of certain types of financial products; reduced investor demand for banking organizations' equity; higher compliance costs; increasing bank consolidation, especially in rural markets; and diminished access to capital markets, among others.

As an alternative, some commenters encouraged the agencies to consider a simple increase in the minimum regulatory capital requirements, arguing that such an approach would provide increased protection to the deposit insurance fund and would increase safety and soundness without adding complexity to the regulatory capital framework. They argued that this approach would also reduce the cost and burden of reforms as compliance systems would require less extensive changes.

Applicability to community banking organizations:

The majority of comments submitted by or on behalf of community banking organizations requested an exemption from the proposed rule and these commenters asked to continue calculating regulatory capital requirements under the agencies' current generally applicable risk-based capital rules. Commenters argued for an exemption on that basis that: (1) community banking organizations have less access to the capital markets relative to larger banking organizations, requiring them to meet the new requirements solely through retained earnings, and (2) the proposals would be unnecessary and inappropriate for the business model and risk profile of community banking organizations, as Basel III was designed for large, internationally active banking organizations in response to a financial crisis attributable primarily to those institutions. These commenters stated that the proposals would drive up their lending costs and reduce the amounts available for lending, especially with respect to small business and residential mortgage lending.

Competitive concerns:

Many commenters raised concerns that implementation of the proposals would create an uneven playing field between banking organizations and other financial services providers. For example, a number of commenters expressed concern that credit unions would be able to gain market share by offering similar products at substantially lower costs. They also argued that other financial service providers, such as foreign banks with significant U.S. operations, members of the Federal Farm Credit System, and entities in the shadow banking industry, would not be subject to the proposed rule, and therefore would have a competitive advantage over banking organizations.

Treatment of accumulated other comprehensive income (AOCI):

A majority of commenters disagreed with the agencies' proposal, consistent with Basel III, to require banking organizations to include the majority of AOCI components in a banking organization's common equity tier 1 capital. They requested that the final rule keep the current treatment in the generally applicable risk-based capital rules, which neutralizes unrealized gains and losses on AFS securities in a banking organization's measure of its regulatory capital.

Commenters argued that recognition of unrealized gains and losses on AFS securities could increase the pro-cyclicality of the capital requirements and lead to increased volatility in capital ratios largely as a result of unrealized temporary gains or losses caused by the normal fluctuation of benchmark market interest rates. The commenters also asserted that the proposed rules would likely impair lending and negatively affect banking organizations' ability to manage liquidity and interest rate risk and to maintain compliance with legal lending limits. Furthermore, commenters from community banking organizations asserted that they lack the sophistication of larger banking organizations to use certain risk management techniques to hedge interest rate risk, such as the use of derivative instruments, and requested an exemption from the proposed AOCI treatment.

Treatment of non-qualifying capital instruments:

Many commenters disagreed with the proposal's phase-out of trust preferred securities and cumulative preferred shares from regulatory capital for all banking organizations, consistent with Basel III. These commenters pointed out that section 171 of the Dodd-Frank Act allows trust preferred securities issued prior to May 19, 2010 to be included in tier 1 capital for banking organizations with less than $15 billion in assets and banking organizations that are mutual holding companies. These commenters requested that the final rule align with this provision of section 171. Commenters also asserted that this aspect of the proposal would unduly burden community banking organizations which have limited ability to raise capital, potentially impairing the lending capacity of these banking organizations.

Treatment of residential mortgage exposures:

The agencies received a significant number of comments objecting to the proposed treatment for 1-4 family residential mortgages and requesting retention of the mortgage treatment under the agencies' generally applicable risk-based capital rules. They generally expressed concern that the proposed treatment would inhibit lending to creditworthy borrowers and could jeopardize the recovery of a still fragile housing market. Commenters also criticized the distinction between the proposed category 1 and category 2 mortgages, asserting that the characteristics the agencies proposed did not adequately distinguish between lower- and higher-risk products and would adversely impact certain loan products that performed relatively well even during the recent crisis. Furthermore, they argued that the proposed risk-weighting for mortgage exposures with high loan-to-value ratios was unnecessarily punitive. Commenters also highlighted concerns regarding regulatory burden and the uncertainty of other regulatory initiatives involving residential mortgages, including the combined impact when considering the final qualified mortgage definition and the finalization of qualified residential mortgage standards.

Impact on the insurance business:

Numerous commenters disagreed with the proposed capital requirements for SLHCs with significant insurance activities. They raised concerns that the proposed requirements would apply "bank-centric" consolidated capital requirements to these entities. Commenters suggested incorporating insurance risk-based capital requirements established by the state insurance regulator into the proposed rule or including certain insurance risk-based metrics that, in the commenters' view, would measure the risk of insurance activities more accurately. A few commenters asked the Board to conduct an additional cost-benefit analysis prior to implementing the proposed capital requirements for these SLHCs. In addition, several commenters expressed concern regarding the burden associated with the proposed requirement to prepare financial statements according to GAAP, because insurance SLHCs generally prepare financial statements according to Statutory Accounting Principles.

Treatment of mortgage servicing assets (MSAs):

Commenters argued that the proposal to deduct MSAs above the 10 and 15 percent thresholds would have significant negative economic consequences, such as forcing banking organizations to sell MSAs to non-bank investors, increasing origination fees, and discouraging community banking organizations from holding MSAs. Many commenters proposed exempting smaller banking organizations or raising the threshold (*e.g.*, to 25 percent).

Treatment of past due exposures:

Commenters expressed general opposition to the proposed 150 percent risk weight. Commenters argued that this charge is pro-cyclical, creates disincentives for workouts, and is highly burdensome to community banking organizations.

Deduction of investments in financial firms:

Commenters opposed the NPRs' requirement to deduct investments above certain thresholds in the capital of unconsolidated financial institutions. Commenters argued it would be challenging to implement due to lack of data on business activities at these entities and tracking the status of firms on an ongoing basis would be too burdensome.