

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: June 4, 2012
To: Board of Governors
From: Governor Tarullo *DT*
Subject: Notices of Proposed Rulemaking: Enhancements to the Regulatory Capital Requirements

Attached are a memorandum to the Board and three draft *Federal Register* notices proposing enhancements to the Board's regulatory capital requirements. The proposed enhancements are designed to address shortcomings in these requirements that became apparent during the recent financial crisis, in part, by implementing in the United States changes made by the Basel Committee on Banking Supervision (BCBS) to international regulatory capital standards. The proposal would revise the federal banking agencies' current minimum risk-based and leverage capital rules to introduce a minimum common equity risk-based capital ratio and, for internationally active banking organizations, a supplementary leverage ratio. The proposal also would restructure the agencies' capital rules into a harmonized, integrated regulatory framework. The framework is being proposed in three parts to make the proposal easier to understand and to clearly identify those aspects of the proposal that would apply to any given banking organization. The draft rules would be proposed jointly by the Board, FDIC, and OCC.

The first *Federal Register* notice would apply to all depository institutions, bank holding companies with consolidated assets of \$500 million or more, and savings and loan holding companies (collectively, banking organizations). It would implement aspects of Basel III, such as re-defining the regulatory capital elements and minimum regulatory capital ratios and introducing regulatory capital buffers above those minimums. It would also revise the prompt corrective action framework to reflect the proposed changes to the regulatory capital requirements.

The second *Federal Register* notice also would apply to all banking organizations identified above and would revise and harmonize the banking agencies' rules for calculating risk-weighted assets to enhance risk sensitivity and address weaknesses identified over recent years, including by incorporating aspects of the BCBS's Basel II standardized approach.

The third *Federal Register* notice would only apply to banking organizations that are subject to the agencies' advanced approaches risk-based capital rule (which are generally only the largest, most internationally active banking organizations) or subject to the market risk capital rule (which are those banking organizations with significant trading activity). This notice would incorporate into the advanced approaches rule revisions that were published by the Basel Committee in a series of documents between 2009 and 2011. This notice would propose to apply the advanced approaches rule to large, internationally active savings and loan holding companies (SLHCs) and the market risk rule to SLHCs with significant trading activity. It also would incorporate the banking agencies' market risk capital rules into the integrated capital framework.

Each of the NPRs addresses relevant provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, including removal of references to credit ratings in the capital rules.

Staff seeks the Board's approval to invite public comment on this proposal for a period of approximately 90 days. Staff also requests authority to make technical and minor changes to the attached materials prior to publication in the *Federal Register*, such as to respond to comments from the *Federal Register*, or to incorporate changes requested by other federal banking agencies as part of the approval process. Staff proposes to discuss any material changes with me, as Chairman of the Committee on Bank Supervision, to determine whether additional action by the Board is required or appropriate.

The Committee on Bank Supervision has reviewed the proposal and I believe it is ready for the Board's consideration.

Attachments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: June 4, 2012
To: Board of Governors
From: Staff¹
Subject: Notices of Proposed Rulemaking - Enhancements to the Regulatory Capital Requirements

ACTIONS REQUESTED: Staff seeks the Board's approval (1) of the three attached draft notices of proposed rulemaking (NPRs, or proposed rules) that revise and enhance the Board's general risk-based capital rule, leverage rule, and advanced approaches risk-based capital rule (advanced approaches rule); incorporate the revised rules and the market risk rule into a new comprehensive capital framework; and apply the comprehensive capital framework to savings and loan holding companies (SLHCs); and (2) to invite public comment on these three proposed rules for a period of approximately 90 days. Staff also requests authority to make technical and minor 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 changes requested by other federal banking agencies as part of the approval process. Staff proposes to discuss any material changes with the Chairman of the Committee on Bank Supervision to determine whether additional action by the Board is required or appropriate. The draft rules would be proposed jointly by the Board, FDIC, and OCC (collectively, agencies) after all agencies have completed their internal review and approval procedures.

DISCUSSION: To address the shortcomings of the international capital standards exposed during the global financial crisis, the Basel Committee on Banking Supervision (BCBS) issued revisions to the standards designed to better reflect the risk of certain exposures, enhance the quantity and quality of regulatory capital in the banking system, and build additional capacity

¹ Messrs. Gibson, Lindo, Boemio, Climent, Conkling, Powell, and Healey and Mmes. Hewko, Horsley, Kirkpatrick and Phelan (Division of Banking Supervision and Regulation) and Messrs. Alvarez and McDonough, Mmes. Snyder and Graham, and Messrs. Alexander and Kress (Legal Division).

into the banking system to absorb losses in times of future market and economic stress.² Staff agrees that the BCBS's changes, commonly termed Basel III, should result in capital requirements that better reflect banking organizations' risk profiles and, combined with certain revisions required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), should enhance their ability to continue functioning as financial intermediaries, particularly during stressful periods. This, in turn, should improve the overall resiliency of the banking system. Quantitative analysis by the Macroeconomic Assessment Group, a working group of the BCBS, 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 the requirements in over time.³ Staff believes that the benefits of these changes to the U.S. financial system, in terms of the reduction of risk to the deposit insurance fund and the financial system, ultimately outweigh the burden on banking organizations of compliance with the new standards.

Taken together, the three NPRs would restructure the agencies' current regulatory capital rules into a harmonized, comprehensive framework, as well as revise the capital requirements to make them consistent with the Basel III capital standards established by the BCBS and certain provisions of the Dodd-Frank Act.⁴ These include the minimum capital requirements for bank holding companies and SLHCs required by section 171 (the so-called "Collins Amendment") and the requirement that all federal agencies remove references to credit ratings in section 939A of the Dodd-Frank Act.⁵

The first NPR would apply to banks, savings associations, bank holding companies with consolidated assets of \$500 million or more, and SLHCs (collectively, banking organizations).⁶

² See <http://www.bis.org/publ/bcbs189.pdf> and <http://www.bis.org/publ/bcbs157.pdf>.

³ See <http://www.bis.org/publ/othp10.pdf> and <http://www.bis.org/publ/bcbs173.pdf>.

⁴ The Board's existing capital requirements for state member banks are found at 12 CFR part 208, subpart E, and in appendices A, B, E, and F, and for bank holding company at 12 CFR part 225, appendices A, D, E, and G.

⁵ See 12 U.S.C. 5371; note to 15 U.S.C. 78o-7.

⁶ The NPRs propose 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

This NPR would increase the quantity and quality of capital required in the banking system by proposing a new common equity tier 1 ratio and higher minimum tier 1 capital ratio based on changes to international capital standards proposed by the BCBS. It also would make substantial changes to the definition of capital to improve the loss absorbency of regulatory capital instruments. For banking organizations subject to the advanced approaches rule, this NPR also would introduce a supplementary leverage ratio based on a new international leverage ratio standard established by the BCBS. Additionally, the first NPR would establish limitations on capital distributions and certain discretionary bonus payments if a banking organization does not hold additional specified amounts or “buffers” of common equity tier 1 capital. The proposal rule also would revise the prompt corrective action (PCA) framework by incorporating the new regulatory capital minimums, introducing a common equity tier 1 capital threshold, and updating the definition of tangible common equity.

The second NPR also would apply to all banking organizations. This NPR would revise and harmonize the banking agencies’ rules for calculating risk-weighted assets to enhance risk sensitivity and address weaknesses identified over recent years, including by incorporating aspects of the BCBS’ Basel II standardized framework. This NPR also would establish calculations for risk-weighted assets using alternatives to credit ratings, consistent with section 939A of the Dodd-Frank Act. Banking organizations that are not subject to the advanced approaches rule or the market risk rule would need to review the first two NPRs only.

The third NPR would only apply to banking organizations that are subject to the advanced approaches rule (advanced approaches banking organizations) or the market risk rule or both. These are generally large, internationally active banking organizations or banking organizations with significant trading activity.⁷ Accordingly, banking organizations subject to

exemption for bank holding companies 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 small SLHCs with total consolidated assets less than \$500 million to the proposed capital standards.

⁷ 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. Based on bank holding company (BHC) regulatory reporting data as of March 31, 2012, BHCs that are currently mandatorily subject to the advanced approaches rule account for over 76 percent of total reported U.S. BHC assets. Market risk banking organizations generally are those with aggregate trading assets and trading liabilities equal to at least 10 percent of quarter-end

the advanced approaches rule or the market risk capital rule would be expected to review all three NPRs. This NPR would enhance the risk sensitivity of the advanced approaches rule, including, among other revisions, by incorporating the changes to the Basel advanced approaches standards to better address counterparty credit risk and interconnectedness among financial institutions. It also would propose applying the advanced approaches rule and market risk capital rule to SLHCs that meet the relevant thresholds. The third NPR additionally would incorporate the market risk rule into the integrated capital framework that would be established by all three proposed rules.

The following summary highlights the most important aspects of the proposed rules. Additional detail concerning each of these matters is located at the identified sections of the applicable draft *Federal Register* notice.

A. First NPR—Regulatory capital minimums, definition of capital, and capital buffers

1. Minimum regulatory capital ratio requirements (See pp. 36-42.)

- 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 tier 1 leverage ratio of 4 percent.⁸
- Due to their more extensive off-balance sheet activities, advanced approaches banking organizations also would be subject to a minimum supplementary tier 1 leverage ratio – based on the Basel III leverage ratio – of 3 percent. The denominator of the supplementary leverage ratio would incorporate certain off-balance sheet exposures such as commitments and derivative exposures. Under the proposal, advanced approaches banking organizations would be required to calculate and report

total assets or \$1 billion. Based on BHC regulatory reporting data as of March 31, 2012, BHCs that are currently subject to the market risk capital rule account for over 79 percent of total reported U.S. BHC assets and for virtually all reported trading assets and trading liabilities.

⁸ Tier 1 capital would be equal to the sum of common equity tier 1 capital and additional tier 1 capital. Total capital would be the sum of common equity tier 1, additional tier 1, and tier 2 capital.

their supplementary leverage ratio beginning on January 1, 2015, and to meet the 3 percent minimum requirement as of January 1, 2018.

- These revised minimum regulatory capital ratios would be incorporated into the agencies' respective PCA rule for insured depository institutions. (See pp. 56-64.)
2. Transition arrangements (See pp. 122-144.) While the rule would be effective as of January 1, 2013, full compliance with most aspects of the rule would not be required until January 1, 2019. Aspects of the rule subject to a transition schedule include minimum capital requirements, the implementation of capital buffers, regulatory capital adjustments and deductions, the phase-out of non-qualifying capital instruments, and calculation of risk-weighted assets using the methodology in the second NPR. These transition requirements are consistent with those proposed in Basel III, adjusted as necessary to comply with section 171 of the Dodd-Frank Act. The proposed transition arrangements aim to provide banking organizations sufficient time to adjust to the new capital framework while limiting any negative economic impact.
 3. Capital conservation buffer (See pp. 43-50.)
 - To avoid restrictions on capital distributions and discretionary bonus payments to executive officers, a banking organization would be required to hold an additional buffer of common equity tier 1 capital in an amount above 2.5 percent of total risk-weighted assets in addition to the minimum common equity tier 1, tier 1, and total capital risk-based capital ratios. This is called the capital conservation buffer.
 - A banking organization would be subject to increasingly stringent limitations on capital distributions and certain discretionary bonus payments if its capital conservation buffer decreases below 2.5 percent of total risk-weighted assets. A banking organization with a capital conservation buffer of zero would not be permitted to make any capital distributions or discretionary bonus payments to executive officers.
 4. Countercyclical capital buffer (See pp. 50-56.)
 - The capital conservation buffer may be expanded for advanced approaches banking organizations upon the activation of the countercyclical capital buffer. At the time the proposed rule becomes effective, the countercyclical buffer amount in the United States would initially be set to zero.

- Under the proposal, the countercyclical buffer in the United States would be triggered when the agencies determine that a period of excessive aggregate credit growth is contributing to an increase in systemic risk. The countercyclical capital buffer amount in the United States could not exceed 2.5 percent of the risk-weighted assets of a banking organization. An advanced approaches banking organization's total countercyclical buffer would be the weighted average of the countercyclical capital buffer amounts established for the national jurisdictions where the banking organization has private sector credit exposures, as applied to the proportion of its private sector exposures that are located in each such jurisdiction (see pp. 53-55 for an example calculation of the countercyclical buffer).

5. Revisions to the definition of capital (See pp. 69-120.)

- The proposed rule would implement qualification criteria for common equity, additional tier 1, and tier 2 capital instruments that help to ensure their ability to absorb losses. As a result, cumulative preferred and trust preferred-like instruments would be excluded from tier 1 capital, which is consistent with section 171 of the Dodd-Frank Act. (See pp. 69-86.)
- The proposed regulatory capital deductions would be stricter than those currently required under the agencies' capital rules, with the greater part of the regulatory deductions taken from common equity tier 1 capital (see pp. 96-122). Examples of the more stringent requirements are:
 - Goodwill, which is the largest deductible item for many banking organizations, would be deducted from common equity tier 1;
 - Deferred tax assets (DTAs) arising from operating losses and tax credit carry forwards would be deducted from common equity tier 1 capital;
 - Mortgage servicing assets (MSAs), DTAs arising from temporary differences that an organization could not realize through net operating loss carry backs, and investments in the common stock of unconsolidated financial institutions each would be individually limited to 10 percent of common equity tier 1 and, in the aggregate, to 15 percent of common equity tier 1; and
 - The amount of minority interests permitted in capital would be more limited.

- Unrealized gains and losses on all available-for-sale securities and gains and losses associated with certain cash flow hedges would flow through to common equity tier 1 capital. Under the agencies' current capital rules, these gains and losses are essentially neutralized when calculating regulatory capital. This change ensures that regulatory capital ratios reflect an institution's loss absorption capacity at all times. (See pp. 72-75.)
- The proposed rule would implement largely the same definitions of regulatory capital for all banking organizations subject to consolidated capital requirements.⁹

B. Second NPR -- Standardized Approach for Risk-weighted Assets

1. Overview

- The second NPR would harmonize the banking agencies' calculation of risk-weighted assets and include an expanded number of risk-weight categories that provide a more granular, risk-sensitive approach to assessing risk-weighted assets, including by implementing aspects of the Basel II standardized approach.
- The standardized approach would address lessons learned from the recent financial crisis by increasing the required capital for certain assets, such as higher-risk residential mortgages, higher-risk construction and commercial real estate lending, and certain securitization exposures. It also would provide incentives for trading and clearing derivatives through central counterparties.
- This NPR would apply to all banking organizations. Advanced approaches banking organizations would use the risk weights in this NPR to calculate their Collins Amendment floor.

2. Significant changes to the calculation of risk-weighted assets

- The proposal includes the use of the OECD's country credit risk classifications (CRCs) to assign risk weights to exposures to sovereign entities. The risk weight for an exposure to a foreign bank or public-sector entity (PSE), such as a state or

⁹ The amount of loan loss reserves included in tier 2 capital would continue to be calculated differently under the standardized and advanced approaches.

- municipality, would be assigned based on the CRC rating of its home country. (See pp. 29-40.)
- This approach is consistent with the approach recommended to the Board for adoption in the final market risk rule and reflects comments received on the approach as proposed by the Board and the other agencies in December 2011. It is also consistent with the international capital standards.
 - The treatment of exposures to the U.S. government, U.S. public sector entities (such as states and municipalities), U.S. government-sponsored entities, and U.S. depository institutions would be unchanged from the current rules.
 - Currently, most residential mortgages are assigned a 50 percent risk weight despite the broad range of risk profiles associated with mortgage exposures. Under the proposed rules, residential mortgage exposures would be 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. (See pp. 41-52.)
 - As demonstrated over several recent economic cycles, certain commercial real estate loans present elevated risks for which banking organizations should hold additional capital. Accordingly, the draft NPR proposes assigning a higher 150 percent risk weight to these exposures. (See pp. 55-56.)
 - Consistent with the international capital standards, the proposal would generally increase the risk weight for exposures that are more than 90 days past due or on nonaccrual to 150 percent. Currently, these assets are generally assigned a 100 percent risk weight. (See pp. 56-57.)
 - The proposed rules would establish several risk weight categories for equity exposures based on the type of exposure and the type of entity that issued the exposure, which is consistent with international capital standards. (See pp. 138-151.)
 - Consistent with the international capital standards, the proposed rules would introduce capital requirements for cleared transactions with central counterparties and for default fund contributions to central counterparties by member banking organizations. (See pp. 69-80)
 - Under the proposed rules, a banking organization would determine the risk-based capital requirement for securitization exposures by applying either 1) the gross-up

- approach in the current capital rules based on the subordination of a securitization exposure (see pp. 133-134) or 2) a simplified supervisory formula approach (SSFA), which is a simplified version of the current supervisory formula approach (SFA) in the advanced approaches rule. (See pp. 128-133.)
- The SSFA was developed as an alternative to credit ratings.
 - The SSFA would generally result in relatively higher capital requirements for the more risky junior tranches of a securitization and relatively lower capital requirements for the most senior positions.
 - The SSFA is consistent with the approach recommended to the Board for adoption in the final market risk rule and reflects comments received on the December 2011 market risk NPR.
 - Banking organizations subject to the market risk rule would be required to use the SSFA under the proposal.
- The NPR also would require, consistent with international standards, that a banking organization demonstrate a comprehensive understanding of material risks associated with its securitization exposures by conducting and documenting an analysis of the risk characteristics of a securitization exposure prior to acquiring the exposure and periodically thereafter. The analysis must consider various aspects of the exposure, as set forth in the second NPR (see pp.116-117). If the banking organization is not able to demonstrate that it has met this requirement, to the satisfaction of its primary federal supervisor, it would be required to assign a risk weight of 1,250 percent to the exposure.
 - The proposed rule also would include additional 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 disclosure requirements. The proposed disclosure requirements include qualitative disclosures related to a banking organization's regulatory capital and various types of assets, including descriptions of a banking organization's policies and procedures for assessing its capital adequacy and for managing risks associated with its assets. They also include quantitative disclosures, such as the amount of each category of regulatory capital the banking

organization holds, and its aggregate risk-weighted asset amount for various categories of assets. (See pp. 158-165.)

C. Third NPR -- Advanced Approaches and Market Risk

1. Advanced approaches rule (See pp. 15-66.)

- The proposed revisions incorporate changes to the international capital standards, including those related to the securitization framework, treatment of counterparty credit risk, and disclosure requirements regarding capital instruments and securitization exposures.
- The proposal includes 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 large percentage of counterparty credit risk loss that was due to CVA during the financial crisis. The requirement is calculated either through a supervisory formula provided in the proposal or an adjustment to a banking organization's market risk models for specific risk (with approval of the banking organization's primary federal supervisor). (See pp. 25-34.)
- The proposed 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. (See pp. 19-22.)
- Consistent with the international capital standards and the second NPR, the proposed rules would introduce advanced approaches capital requirements for cleared transactions with central counterparties and for default fund contributions to central counterparties by member banking organizations. This proposal is based upon the Basel consultative paper *Capitalization of bank exposures to central counterparties*.¹⁰ (See pp. 35-39.)
- To recognize the high correlation of financial institutions' creditworthiness due to sensitivity to common risk factors, and consistent with Basel III, the proposal would

¹⁰ See <http://www.bis.org/publ/bcbs206.pdf>

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 enhanced requirement would be implemented by increasing an input in the supervisory formula for calculating the capital requirement for these exposures under the advanced approaches rule. (See pp. 25-26.)

- The proposed rule would remove 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 supervisory formula approach (SFA) or a simplified version of the SFA (SSFA) for an advanced approaches banking organization to calculate its capital requirement for securitization exposures. (See pp. 49-53.)
- Advanced approached banking organizations also would be subject to enhanced standards, such as due diligence requirements, parallel to those proposed in the second NPR. (See p. 53.)

2. Market risk capital rule (See pp. 66-69.)

- The draft final rule for market risk that the Board is also considering today would apply only to banks and bank holding companies, but does not apply to SLHCs. This NPR would:
 - Integrate the agencies' market risk capital rule into the comprehensive capital framework, and
 - Implement the market risk capital rule for certain savings and loan holding companies.

CONCLUSION: Staff recommends that the Board invite public comment on the rules described in the attached draft joint *Federal Register* notices. If approved, the *Federal Register* notices would be published jointly by the agencies, and the proposed rules would be available for public comment for a period of approximately 90 days. Staff requests authority to make technical and minor changes to the attached materials prior to publication in the *Federal Register*, such as to respond to comments from the *Federal Register*, or to incorporate changes requested by other agencies as part of the approval process. Staff proposes to discuss any material changes with the Chairman of the Committee on Bank Supervision to determine whether additional action by the Board is required or appropriate.