September 27, 2017

MEMORANDUM TO: Board of Directors [redacted]

FROM: Doreen R. Eberley, Director [redacted]
Division of Risk Management Supervision

SUBJECT: Regulatory Capital Rule: Simplification to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996

Summary: In March 2017, the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("FRB"), and the Federal Deposit Insurance Corporation ("FDIC") (collectively, the "agencies") submitted a report to Congress pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996 ("the 2017 EGRPRA report"), in which they committed to meaningfully reduce regulatory burden on community banking organizations. In accordance with the 2017 EGRPRA report, staff now is seeking the approval of the FDIC Board of Directors ("FDIC Board") to publish the attached interagency proposed rule ("proposed rule") that would simplify compliance with certain aspects of the capital rule.

A majority of the proposed simplifications would apply to banking organizations that are not subject to the advanced approaches of the regulatory capital rule ("non-advanced approaches

Concur:

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Charles Yi
General Counsel

banking organizations"), which would include most FDIC-supervised institutions.[1] The agencies are proposing that covered banking organizations apply a simpler regulatory capital treatment for: (i) mortgage servicing assets ("MSAs"); (ii) certain deferred tax assets arising from temporary differences ("temporary difference DTAs"); (iii) investments in the capital of unconsolidated financial institutions; and (iv) capital issued by a consolidated subsidiary of a banking organization and held by third parties ("minority interest"). The agencies also are proposing to revise the treatment of certain acquisition, development, or construction ("ADC") loans that are designed to address comments regarding the current definition of high volatility commercial real estate ("HVCRE") under the capital rule's standardized approach,[2] which would apply to both non-advanced approaches banking organizations (including community banking organizations) and advanced approaches banking organizations, the latter with respect to their calculation of the standardized approach floor. In addition to the proposed simplifications, the agencies also are proposing various additional clarifications and technical amendments to the agencies' capital rule.

Recommendation: Staff recommends that the FDIC Board approve the proposed rule and authorize its publication in the *Federal Register* with a public comment period that closes 60 days after publication.

[1] Non-advanced approaches banking organizations have less than $250 billion in consolidated assets or less than $10 billion in consolidated on-balance sheet foreign exposures.
[2] All FDIC-supervised institutions determine their risk weights under the standardized approach. The standardized approach is provided in Subpart D of the capital rule. 12 CFR part 324, subpart D.

Discussion:

The capital rule adopted by the agencies in 2013 addressed weaknesses that became apparent during the financial crisis of 2007-08.[3] The capital rule strengthened the capital requirements applicable to banking organizations supervised by the agencies, in part, by implementing more stringent requirements for regulatory capital instruments, revising capital deductions, and increasing the risk-sensitivity of the capital rule.[4] Specifically, the capital rule (1) includes limits on the amount of capital that can count toward regulatory requirements in cases in which a banking organization's consolidated subsidiary has issued capital that is held by third parties (minority interest),[5] and (2) also requires that MSAs, temporary difference DTAs, and investments in the capital of unconsolidated financial institutions above certain thresholds be deducted from regulatory capital.[6]

Since the issuance of the capital rule in 2013, banking organizations (including FDIC-supervised institutions) have raised concerns regarding the regulatory burden, complexity, and costs associated with the capital rule. In addition, in connection with the agencies' review under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA),[7] for which the agencies sought comment through *Federal Register* notices published in 2014 and 2015, the

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[3] The FRB and the OCC issued a joint final rule on October 11, 2013 (78 FR 62018) and the FDIC issued a substantially identical interim final rule on September 10, 2013 (78 FR 55340). In April 2014, the FDIC adopted the interim final rule as a final rule with no substantive changes. 79 FR 20754 (April 14, 2014).

[4] 12 CFR part 324.

[5] 12 CFR 324.21.

[6] 12 CFR 324.22(c)(4), (c)(5), and (d)(1).

[7] EGRPRA requires that regulations prescribed by the agencies be reviewed at least once every 10 years and identify, with input from the public, outdated or unnecessary regulations and consider how to reduce regulatory burden on insured depository institutions while, at the same time, ensuring their safety and soundness and the safety and soundness of the financial system. Public Law 104-208, 110 Stat. 3009 (1996).

agencies received in response over 230 comment letters.[8] The agencies also received numerous oral and written comments from panelists and the public at outreach meetings that the capital rule is unduly burdensome and complex. Based on these comments, the agencies issued the 2017 EGRPRA report.[9] In the 2017 EGRPRA report, the agencies highlighted their intent to meaningfully reduce regulatory burden, especially on community banking organizations, while at the same time maintaining safety and soundness and the quality and quantity of regulatory capital in the banking system.

Consistent with the 2017 EGRPRA report, the proposed rule would: (i) replace the current treatment of HVCRE exposures with a simpler treatment for most ADC loans; (ii) simplify the current regulatory capital treatment for MSAs, temporary difference DTAs, and investments in the capital of unconsolidated financial institutions; and (iii) simplify the calculation for the amount of minority interest that can be included in a banking organization's regulatory capital. In addition, the proposed rule would make various clarifications and technical amendments to the agencies' capital rule, including the advanced approaches capital rule.[10]

I. New Treatment of ADC Loans

Under the capital rule, an HVCRE exposure is defined as any credit facility that, prior to conversion to permanent financing, finances or has financed the acquisition, development, or construction of real property, unless the facility finances one- to four-family residential

[8] 79 FR 32172 (June 4, 2014); 80 FR 7980 (February 13, 2015); 80 FR 32046 (June 5, 2015); and 80 FR 79724 (December 23, 2015).
[9] 82 FR 15900 (March 30, 2017).
[10] According to data from the Call Report as of June 30, 2017, 2589 FDIC-supervised, small banking entities reported holding some acquisition, development or construction loans (excluding one- to four-family residential projects), MSAs, DTAs, deductions related to investments in unconsolidated financial institutions, and minority interests included in regulatory capital. (The Small Business Administration has defined "small entities" to include banking organizations with total assets less than or equal to $550 million.)

properties, certain agricultural or community development exposures, or commercial real estate projects where the borrower meets certain contributed capital requirements and other prudential criteria. The 2013 capital rule prescribed a 150 percent risk weight for HVCRE exposures. Other commercial real estate exposures typically receive a risk weight of 100 percent under the standardized approach.

Community banking organizations have asserted that the current HVCRE exposure definition is unclear, overly complex, and burdensome to implement, and is not being applied consistently across banking organizations. The proposed rule would simplify the treatment of these ADC exposures while retaining increased capital requirements for exposures that meet the criteria for higher risk ADC activities.

Under the proposed rule, a new exposure category — high volatility acquisition, development, or construction exposure ("HVADC exposure") — would replace the definition of an HVCRE exposure in the standardized approach. An HVADC exposure would be defined as a credit facility that primarily finances or refinances: (i) the acquisition of vacant or developed land; (ii) the development of land to prepare to erect new structures, including, but not limited to, by laying sewers or water pipes and demolishing existing structures; or (iii) the construction of buildings or dwellings, including additions or alterations to existing structures. The proposed HVADC exposure definition would retain certain exclusions pertaining to one- to four-family residential properties, agricultural or community development exposures. The proposal clarifies that loans that are not "primarily" to finance ADC are exempt from being categorized as HVADC. The proposal also clarifies the existing exemption for permanent financings. Staff believes these provisions in the new HVADC exposure definition would appropriately clarify the exemptions for some types of loans for which FDIC-supervised banks have been uncertain about the appropriate treatment under the current HVCRE exposure definition. Finally, the proposed HVADC exposure definition would eliminate the existing exclusion for commercial real estate projects that meet certain conditions regarding borrower equity and other prudential criteria. Eliminating the borrower equity exemption would address an aspect of the current capital rule that has generated a significant volume of questions and confusion from bankers and examiners.

In light of the proposed changes to the exemptions, the new HVADC exposure definition likely would capture more ADC loans than under the current HVCRE exposure definition. Accordingly, the proposed rule would reduce the applicable risk weight from 150 percent (for HVCRE exposures) to 130 percent (for HVADC exposures) under the standardized approach. Because of the proposed clarifications, ADC exposures currently receiving a 150 percent risk weight as HVCRE would receive either a 130 percent risk weight or a 100 percent risk weight, depending upon the availability of exemptions. Similarly, ADC exposures currently receiving a 100 percent risk weight would receive either a 100 percent risk weight or a 130 percent risk weight, depending upon the availability of exemptions. These changes in risk weights would apply only to new ADC loans, as discussed below. Any changes in capital requirements for ADC loans as a result of the proposal would depend on the nature of the loan mix at individual institutions going forward. Staff believes any change in capital requirements for ADC loans under this proposal is likely to be modest.

Although staff anticipates that the proposed rule may lead to the assignment of higher risk weights to certain ADC exposures going forward, staff believes that the new HVADC exposure definition is simpler to apply and may lessen the compliance burden for insured depository institutions and result in increased consistency in the treatment of ADC exposures.

Staff also believes that the proposed definition strikes an appropriate balance between risk sensitivity and complexity.

II. Grandfathering of Outstanding HVCRE Exposures

To mitigate the potential burden on banking organizations of having to re-evaluate all of their ADC exposures against the new HVADC exposure definition and to also limit the potential impact of the proposed rule on banking organizations' regulatory capital, the proposal would contain a grandfathering provision for outstanding ADC exposures. Under this provision, a banking organization would maintain an ADC exposure's risk weight as it was determined prior to the effective date of a final rule using the HVCRE exposure definition. Only new ADC exposures originated on or after the effective date of a final rule would be evaluated against the new HVADC exposure definition.

Under the proposed rule, advanced approaches banking organizations would use the HVADC exposure definition for the purpose of calculating their risk-weighted assets under the standardized approach. However, advanced approaches banking organizations would continue to use the HVCRE exposure definition to calculate their risk-weighted assets under the advanced approaches.

III. MSAs, Temporary Difference DTAs, and Investments in the Capital of Unconsolidated Financial Institutions

Historically, the agencies have limited the inclusion of intangible and higher-risk assets in capital due to the relatively high level of uncertainty regarding the ability of banking organizations to realize value from these assets, especially under adverse financial conditions. The capital rule requires that a banking organization deduct from common equity tier 1 capital the amount of MSAs, temporary difference DTAs, and significant investments in the capital of unconsolidated financial institutions in the form of common stock that individually exceeds 10 percent of the banking organization's common equity tier 1 capital[11] (with an aggregate deduction for all such items that exceeds 15 percent of a banking organization's common equity tier 1 capital).

The capital rule further requires that a banking organization deduct from its capital any amount of the non-significant investments in unconsolidated financial institutions[12] that exceeds 10 percent of the banking organization's common equity tier 1 capital.[13],[14] In addition, significant investments in unconsolidated financial institutions not in the form of common stock must also be deducted from capital in their entirety.

Community banking organizations have indicated that the deduction approach for MSAs, temporary difference DTAs, and investments in the capital instruments of unconsolidated financial institutions is complex and burdensome. Accordingly, the proposed rule would streamline the capital rule's requirements for MSAs, temporary difference DTAs, and investments in the capital of unconsolidated financial institutions for non-advanced approaches banking organizations by requiring that such organizations deduct from common equity tier 1 capital any amount of MSAs, temporary difference DTAs, and all investments in the capital of

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[11] A significant investment in the capital of an unconsolidated financial institution is defined as an investment in the capital of an unconsolidated financial institution where the banking organization owns more than 10 percent of the issued and outstanding common stock of the unconsolidated financial institution (significant investment in the capital of an unconsolidated financial institution). *See* 12 CFR 324.2.

[12] A non-significant investment in the capital of an unconsolidated financial institution is defined as an investment in the capital of an unconsolidated financial institution where the institution owns 10 percent or less of the issued and outstanding common stock of the unconsolidated financial institution (non-significant investment in the capital of an unconsolidated financial institution). *See* 12 CFR 324.2.

[13] 12 CFR 324.22(c)(4).

[14] 12 CFR 324.22(c)(2).

unconsolidated financial institutions that individually exceed 25 percent of common equity tier 1 capital.

Advanced approaches banking organizations would be required to continue to be subject to the deduction treatments in the current capital rule for MSAs, temporary difference DTAs, and investments in the capital of unconsolidated financial institutions.

IV. Minority Interest

The capital rule limits the amount of minority interest that a banking organization may include in regulatory capital. For example, minority interest is created when a consolidated subsidiary of the banking organization issues common stock to third parties. Given that minority interest is generally not available to absorb losses at the banking organization's consolidated level, the inclusion of minority interest in a banking organization's regulatory capital is limited by the capital rule. The capital rule's limitations regarding such minority interest are based on the capital requirements and capital ratios of each of a banking organization's consolidated subsidiaries that has issued capital instruments to third parties. Many community banking organizations have asserted that the calculation of the minority interest limitation is complex and results in burdensome and confusing regulatory capital reporting requirements.

The proposed rule would replace, for non-advanced approaches banking organizations, the existing calculations limiting the inclusion of minority interest in regulatory capital with a simpler calculation. Specifically, the proposed rule would permit a non-advanced approaches banking organization to include minority interest up to and including 10 percent of the banking organization's common equity tier 1, tier 1, and total capital, respectively. Advanced approaches banking organizations, however, would be required to continue to apply the treatment of minority interest provided in the current capital rule.

V. Technical Amendments

Finally, the proposed rule would make certain technical changes to the capital rule, including some changes to the advanced approaches rule, such as clarifying revisions, updating cross references, and correcting typographical errors.

Conclusion:

FDIC staff recommends that the FDIC Board approve the attached proposed rule and authorize its publication in the *Federal Register* with a public comment period that closes 60 days after publication.

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