

August 25, 2017

Banking Organization Capital Requirements

Federal Banking Agencies Propose Extension of Certain Transitional Provisions for Non-Advanced Approaches Banking Organizations

On August 22, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation published a proposed rule¹ that would extend the existing transitional regulatory capital treatment for certain capital deductions, risk weightings and minority interest requirements for banking organizations that are not subject to the agencies' advanced approaches capital rules.² As discussed in further detail below, the affected existing transitional provisions are those for mortgage servicing assets, certain deferred tax assets, investments in the capital instruments of unconsolidated financial institutions, and minority interests.

The agencies indicated that their proposal to freeze in place the current treatment of these items for non-advanced approaches banking organizations, without requiring those organizations to apply the more stringent standards that otherwise come into effect after December 31, 2017 as the capital rules are fully phased-in, is a temporary step pending the agencies' preparation of a forthcoming proposal to simplify the regulatory capital treatment of these items for non-advanced approaches banking organizations. Notably, the agencies:

- did not comment on the potential content or impact of the contemplated simplification for non-advanced approaches banking organizations, including whether it might permanently apply more favorable capital standards to the affected items for these organizations;
- limited their explanation as to the dichotomy between non-advanced and advanced approaches banking organizations to the statement that “[t]he agencies believe that ... given the business models and risk profiles of [the advanced approaches banking organizations] ... the current treatment for these items strikes an appropriate balance between complexity and risk sensitivity for the largest banking organizations”;³
- did not seek comment on whether the more stringent capital treatment for the affected items remains the appropriate standard for any banking organization; and

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- did not discuss the current debate among banking regulators regarding the general continuation of the advanced approaches, or the potential impact of the outcome of this debate on the affected items.

Comments on the proposed rule are due by September 25, 2017.

Key Elements of the Proposal

- **Items subject to the extension.** For non-advanced approaches banking organizations only, the agencies propose to extend the current regulatory capital treatment⁴ of the following items. The extension would continue until the forthcoming capital simplification proposal (discussed in further detail below) is completed “or the agencies determine otherwise.”
 - **MSAs, temporary difference DTAs, and certain investments in the capital of unconsolidated financial institutions.** The agencies’ capital rules require that amounts of the following items that exceed certain thresholds be deducted from a banking organization’s regulatory capital: (i) mortgage servicing assets (or MSAs), (ii) deferred tax assets (or DTAs) arising from temporary differences that could not be realized through net operating loss carry backs, (iii) significant investments in the capital of unconsolidated financial institutions in the form of common stock, (iv) non-significant investments in the capital of unconsolidated financial institutions, and (v) significant investments in the capital of unconsolidated financial institutions that are not in the form of common stock.
 - Under the proposal, with respect to items (i) through (iii) above, non-advanced approaches banking organizations would continue to: deduct from regulatory capital 80 percent of the amount not includable in regulatory capital, and apply a 100 percent risk weight to any amount not deducted from capital.
 - With respect to items (iv) and (v) above, non-advanced approaches banking organizations would continue to: deduct from regulatory capital 80 percent of the amount not includable in regulatory capital, and apply the current risk weight under the capital rules to any amount not deducted from capital.⁵
 - **Common equity tier 1 minority interest, tier 1 minority interest, and total capital minority interest exceeding the capital rules’ minority interest limitations:** The capital rules include limits on the amount of capital that would count toward regulatory requirements in cases where the capital is issued by a consolidated subsidiary of the banking organization and not owned by the banking organization. Under the proposal, non-advanced approaches banking organizations would continue to include 20 percent of any amount exceeding the capital rules’ minority interest limitations (surplus minority interest) in regulatory capital.⁶
 - **Banking organizations subject to the extension.** Because the proposal does not apply to advanced approaches banking organizations, these firms would be required to continue to apply the existing transition provisions in the capital rules and, beginning on January 1, 2018, would apply the fully phased-in regulatory capital treatment for the items noted above.
 - Although not expressly addressed in the proposal, the extensions would appear not to be available to intermediate holding companies (IHCs) of foreign banking organizations that have more than \$250 billion in total consolidated assets or \$10 billion in foreign exposure (the thresholds for application of the advanced approaches under the agencies’ capital rules). Although these IHCs are not subject to the requirement to determine their risk-based capital requirements under the agencies’ advanced approaches rules,⁷ they are “nonetheless subject to the other requirements that apply to advanced approaches banking organizations.”⁸ The transitional provisions for the items noted above would constitute “aspects of the revised capital framework that apply to institutions that meet the thresholds for application of the advanced approaches rules, but are not part of the advanced approaches rules” themselves.⁹
 - **Context for the proposal.** In March 2017, the Federal Financial Institutions Examination Council (FFIEC) released its report on the second Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) review to Congress. Under EGRPRA, the FFIEC and its member agencies¹⁰ are

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directed to conduct a joint review of their regulations every 10 years and consider whether any of those regulations are outdated, unnecessary, or unduly burdensome. The March 2017 EGRPRA report identified community banking organization concerns with the compliance burden associated with the revised capital rules. In response to these concerns, the agencies stated that they are “developing a proposal to simplify the regulatory capital rules in a manner that maintains safety and soundness and the quality and quantity of regulatory capital in the banking system,” indicating that amendments likely would include, among other things, simplifying (i) the current regulatory capital treatment for MSAs, timing difference DTAs, and holdings of regulatory capital instruments issued by financial institutions, and (ii) the current limitations on minority interests in regulatory capital.¹¹

- In the proposal, the agencies noted that they expect “in the near term” to issue a separate proposal seeking public comment on a proposed rule to simplify the regulatory capital treatment of these items for non-advanced approaches banking organizations.¹²
- To “avoid [a] potential burden on banking organizations that may be subject in the near future to a different regulatory capital regime for these items,” the extension of the transitional provisions as outlined in the proposal would continue to apply to non-advanced approaches banking organizations until the agencies complete their separate rulemaking or otherwise determine.¹³
- **Related regulatory reports.** The agencies also propose to clarify the reporting instructions for certain impacted regulatory reports to reflect the changes to the capital rules that would be required under the proposal.¹⁴

The agencies specifically request comment “more narrowly on the changes proposed” in this proposal while deferring comments on simplification more broadly until a separate proposal is published for notice and comment at a later date.

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ENDNOTES

- 1 Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation, *Regulatory Capital Rules: Retention of Certain Existing Transition Provisions for Banking Organizations that are not Subject to the Advanced Approaches Capital Rules*, 82 Fed. Reg. 40495 (Aug. 25, 2017).
- 2 Advanced approaches banking organizations are generally those with \$250 billion or more in total consolidated assets or \$10 billion or more in foreign exposures (including subsidiary depository institutions of bank holding companies that meet one of these thresholds).
- 3 The proposal, at 40497.
- 4 Currently applicable transition provisions can be found at 12 C.F.R. § 3.300 (OCC), 12 C.F.R. § 217.300 (Federal Reserve) and 12 C.F.R. § 324.300 (FDIC).
- 5 For non-advanced approaches banking organizations, the agencies propose to add an additional “special transition provision” to section 300 of their respective capital rules (applicable to the risk weight and deduction treatment for mortgage servicing assets, temporary differences in deferred tax assets, significant investments in unconsolidated financial institutions in the form of common stock, non-significant investments in the capital of unconsolidated financial institutions, and significant investments in the capital of unconsolidated financial institutions that are not in the form of common stock) that would continue to apply the transition provisions described in paragraphs (b)(4)(i), (ii), and (iii) applicable to calendar year 2017 items.
- 6 The agencies would also bifurcate the provisions in section 300 on surplus minority interest to include separate provisions applicable to advanced approaches and non-advanced approaches institutions, respectively, whereby non-advanced approaches banking organizations would continue to include in regulatory capital 20 percent of the common equity tier 1, tier 1 and total capital minority interest that exceed the includable amounts for each.
- 7 Under 12 C.F.R. § 252.153, a foreign banking organization with U.S. non-branch assets of \$50 billion or more is required to establish a U.S. intermediate holding company. These U.S. intermediate holding companies are not required to comply with the provisions set forth in 12 C.F.R. Part 217, subpart E (the Internal Ratings-Based and Advanced Measurement Approaches).
- 8 Federal Reserve System, *Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations*, Final Rule, 79 Fed. Reg. 17240, 17281 (Mar. 27, 2014).
- 9 *Id.*
- 10 The member agencies of the FFIEC are the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the National Credit Union Administration. The National Credit Union Administration, although an FFIEC member, is not a “federal banking agency” within the meaning of EGRPRA and so is not required to participate in the review process but elected to participate in the EGRPRA review and conducted its own parallel review of its regulations.
- 11 Federal Financial Institutions Examination Council, Joint Report to Congress, Economic Growth and Regulatory Paperwork Reduction Act (March 2017).
- 12 The proposal, at 40498.
- 13 *Id.*, at 40498 and 40495.
- 14 These regulatory reports would include the Consolidated Reports of Condition and Income (Call Report) (FFIEC 031, 041 and 051), the OCC DFAST 14A, the FDIC DFAST 14A, the FR Y-9C, the FR Y-14A and the FR Y-14Q.

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