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FINANCIAL MARKETS CLIENT ALERT

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Final Rule on Regulatory Capital Standards Related to Adoption of FAS 166 and 167

On December 16, 2009, the Board of Directors of the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Office of Thrift Supervision (together, the "Agencies") gave final approval to general risk-based and advanced risk-based capital rules (collectively, the "Final Rule") related to the Financial Accounting Standards Board's ("FASB") adoption of Statement of Financial Accounting Standards No. 166, Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140 ("FAS 166), and Statement of Financial Accounting Standards No. 167, Amendments to FASB Interpretation No. 46(R) ("FAS 167"). Beginning in 2010, FAS 166 and FAS 167 are expected to require certain banking organizations to consolidate certain securitized assets that are currently excluded from these organizations' balance sheets.

The Final Rule (a) eliminates the exclusion of certain consolidated asset-backed commercial paper programs from risk-weighted assets; (b) provides for an optional two-quarter implementation delay followed by an optional two-quarter partial implementation of the effect on risk-weighted assets that will result from changes to U.S. generally accepted accounting principles ("GAAP") FAS 166 and FAS 167; (c) provides for an optional two-quarter delay, followed by an optional two-quarter phase-in, of the application of the Agencies' regulatory limit on the inclusion of the allowance for loan and lease losses ("ALLL") in tier 2 capital for the portion of the ALLL associated with the assets a banking organization consolidates as a result of FAS 167; and (d) provides a reservation of authority to permit the Agencies to require banking organizations to treat entities that are not consolidated under the revised accounting standards as if they were consolidated for risk-based capital purposes, commensurate with the risk relationship of the banking organization to the structure. The delay and subsequent phase-in periods of the implementation will apply only to the Agencies' risk-based capital requirements, and not to the Leverage Ratio requirement (as defined and described below).

I. BACKGROUND

A. The Effects of FAS 166 and 167 on Regulatory Capital

The Agencies' general risk-based capital rules[1] and the advanced risk-based capital approach rules[2] for banking organizations (collectively the "Risk-Based Capital Rules") establish capital requirements intended to reflect the risks associated with on-balance sheet exposures as well as off-balance sheet exposures, such as guarantees, commitments, and derivative transactions. The Agencies use GAAP as the initial basis for determining whether an exposure is treated as

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[1] 12 CFR part 3, appendix A (OCC); 12 CFR parts 208 and 225, appendix A (Board); 12 CFR part 325, appendix A (FDIC); and 12 CFR part 567, subpart B (OTS). The Risk-Based Capital Rules generally do not apply to bank holding companies with $500 million or less in consolidated assets.
[2] 12 CFR part 3, appendix C (OCC); 12 CFR part 208, appendix F; and 12 CFR part 225, appendix G (Board); 12 CFR part 325, appendix D (FDIC); 12 CFR 567, Appendix C (OTS).

on- or off-balance sheet for risk-based capital purposes. Additionally, the Agencies' leverage measure (the "Leverage Rule")[3] uses consolidated on-balance sheet assets as the basis for setting minimum capital requirements that are intended to limit the degree to which a banking organization can leverage its equity capital base.

On June 12, 2009, FASB issued FAS 166 and FAS 167. FAS 166 and FAS 167, among other things, establish new standards for reporting companies' transfers of assets to special purpose entities known as variable interest entities ("VIEs") under GAAP and for consolidating VIEs. Under FAS 166 and FAS 167, banking organizations may be required to consolidate assets, liabilities, and equity in certain VIEs that were not consolidated under the standards that FAS 166 and FAS 167 replaced. Most banking organizations[4] will be required to implement the new consolidation standards as of January 1, 2010, while some banking organizations that use annual reporting periods other than the calendar year will implement the new standards at the beginning of their first annual reporting period that starts after November 15, 2009 (the "Implementation Date"), including interim periods therein, and for interim and annual periods thereafter. The Agencies' Risk-Based Capital Rule and Leverage Rule (collectively, the "Capital Rules") generally would require banking organizations to include assets held by newly consolidated VIEs in their leverage and risk-based capital ratios determined under those rules. VIEs that are likely to be consolidated by banking organizations as a result of FAS 167 include VIEs associated with (a) ABCP programs; (2) revolving securitizations structured as master trusts, including credit card and home equity line of credit securitizations; (c) certain mortgage loan securitizations not guaranteed by the U.S. government or a U.S. government-sponsored agency; and (d) certain term loan securitizations in which a banking organization retains a residual interest and servicing rights, including some student loan and automobile loan securitizations.

At the same time, consolidating banking organizations may need to establish an allowance for ALLL to cover estimated credit losses on the assets consolidated under FAS 167. Under the Risk-Based Capital Rules, ALLL is a component of tier 2 capital and, therefore, included in the numerator of the total risk-based capital ratio. However, the amount of ALLL that may be included in tier 2 capital is limited to 1.25% of gross risk-weighted assets under the Risk-Based Capital Rules. As a consequence, absent a change in the Capital Rules and all other factors remaining constant, both the leverage and risk-based capital ratios of banking organizations that must consolidate VIEs that they did not previously consolidate due to FAS 167 are likely to fall by varying amounts.

B. Notice of Proposed Rulemaking

On September 15, 2009, in anticipation of banking organizations' implementation of FAS 166 and FAS 167, the Agencies published for comment a notice of proposed rulemaking (the "NPR")[5] that solicited information and views from the public regarding the effect FAS 166 and FAS 167 would have on the regulatory capital levels held by banks engaged in securitizations and financings that often had not previously been consolidated under applicable GAAP. The NPR also proposed, among other things, to modify the Agencies' Risk-Based Capital Rules by eliminating provisions that have traditionally permitted a banking organization to exclude assets of consolidated asset-backed commercial paper ("ABCP") programs from risk-weighted assets (the "ABCP Exclusion") and instead assess a risk-based capital requirement against any contractual exposures of the banking organization to such ABCP programs. The NPR also proposed eliminating an associated provision in the general Risk-Based Capital Rules (incorporated by reference in the advanced approaches) that excludes from tier 1 capital the minority interest in a consolidated ABCP program not included in a banking organization's risk-weighted assets. In addition, the NPR proposed a new reservation of authority for the Agencies' Risk-Based Capital Rules to permit a banking organization's primary federal supervisor to treat entities that are not consolidated under GAAP as if they were consolidated for risk-based capital purposes, commensurate with the risk relationship of the banking organization to the entity.

II. FINAL RULE

A. Transition Mechanism for Risk-Based Capital Requirements Associated with the Implementation of FAS 166 and FAS 167

In order to avoid abrupt adjustments that could undermine or complicate government actions to support the provision of credit to U.S. households and businesses in the current economic environment, the Final Rule provides banking organizations with an optional two-quarter implementation delay followed by an optional two-quarter partial implementation of the effect of FAS 167 on risk-weighted assets and ALLL includable in tier 2 capital. More specifically, the transition mechanism consists of: (a) through the

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3 12 CFR part 3 (OCC); 12 CFR part 208, appendix B and 12 CFR part 225 appendix D (Board); 12 CFR 325.3 (FDIC); 12 CFR 567.8 (OTS).
4 Unless otherwise indicated, the term "banking organization" includes banks, savings associations, and bank holding companies ("BHCs"). The terms "bank holding company" and "BHC" refer only to bank holding companies regulated by the Board of Governors of the Federal Reserve System.
5 74 Fed.Reg. 47,138 (Sept. 15, 2009).

end of the second quarter after the Implementation Date of FAS 166 and FAS 167 for a banking organization, an optional two-quarter delay of recognition of the effect on risk-weighted assets and ALLL includable in tier 2 capital that results from a banking organization's implementation of FAS 167 and (b) for a banking organization that has opted for the delay, an optional phase-in of those effects over the next two quarters. A banking organization that chooses to implement this transition mechanism must apply it to all relevant VIEs. The effect of the transition mechanism on a banking organization's risk-based capital ratios would be reflected in the regulatory capital information that the organization reports in its regulatory reports[6] for the four quarter-end regulatory report dates following the bank's Implementation Date.

The transition mechanism is optional because it requires a banking organization choosing the option to prepare and maintain two sets of financial records for affected VIEs for the duration of the delay and partial implementation periods—thus to account separately for financial reporting under GAAP and for regulatory capital reporting based on contractual exposure to VIEs—a requirement that may be burdensome. A banking organization generally would adopt the transition mechanism as of the date it implements FAS 166 and FAS 167.

1. Transition for Risk-Weighted Assets.

During the banking organization's first two quarters after the date it implements FAS 166 and FAS 167 (the "Exclusion Period"), including for the two calendar quarter-end regulatory report dates within the Exclusion Period, the banking organization may choose to exclude from risk-weighted assets those assets held by VIEs the banking organization must consolidate after implementing FAS 167, provided that (a) the VIE existed prior to the banking organization's Implementation Date and (b) the banking organization did not consolidate the VIE on its balance sheet for quarter-end regulatory reporting dates prior to the Implementation Date. During the Exclusion Period, the banking organization may also exclude from risk-weighted assets those assets held by VIEs that are consolidated ABCP programs, provided that (a) the banking organization is the sponsor of the ABCP program and (b) the banking organization consolidated the VIE onto its balance sheet under GAAP prior to the Implementation Date.

However, a banking organization electing to exclude assets pursuant to this transition mechanism may not exclude from risk-weighted assets the assets of any VIEs to which the banking organization has provided recourse through credit enhancement beyond any contractual obligation to support assets it has sold ("Implicit Support"). Thus, during the Exclusion Period, the banking organization would at a minimum include in risk-weighted assets an amount equal to the risk-weighted assets it would have been required to calculate for its contractual exposures to these VIEs (including direct-credit substitutes, recourse obligations, residual interests, liquidity facilities and loans) under the Risk-Based Capital Rules prior to its implementation of FAS 166 and FAS 167. It is expected that banking organizations would calculate risk-weighted assets using methodology similar to the methodology used to calculate the risk weights of exposures to ABCP programs pursuant to the ABCP Exclusion.

For the first and second quarters after the Implementation Date, including for the two quarter-end regulatory report dates within those quarters, a banking organization that chooses to adopt the optional transition mechanism may exclude from risk-weighted assets the amount of risk-weighted assets that would be added to a banking organization's risk-weighted assets as a result of its consolidation of VIEs (the "Exclusion Amount") pursuant to FAS 167 as of the Implementation Date of FAS 166 and FAS 167 (the "Measurement Date") as described above. For the third and fourth quarters after the Implementation Date (the "Phase-in Period"), including for the two quarter-end regulatory report dates within those quarters, a banking organization that has adopted the optional transition mechanism for the first two quarters may exclude from risk-weighted assets 50% of the Exclusion Amount. Under no circumstances, however, may the banking organization include in risk-weighted assets an amount less than the aggregate risk-weighted assets it held based on its contractual exposures to these VIEs on the Measurement Date, had the VIEs not been consolidated. The floor on risk-weighted assets ensures that, notwithstanding these transition provisions, a banking organization always calculates risk-weighted assets in a manner that at a minimum reflects its contractual risk exposure to its consolidated VIEs on the Measurement Date.

2. Transition for Allowance for Loan and Lease Losses

During the Exclusion Period, including for the two calendar quarter-end regulatory report dates within the Exclusion Period, a banking organization that implements the transition mechanism for risk-weighted assets described above by excluding assets of consolidated VIEs from risk-weighted assets may also include without limit in tier 2 capital the full amount (the "Inclusion

6 For banks, Schedule RC-R of the Consolidated Reports of Condition and Income (Call Report); for savings associations, Schedule CCR of the Thrift Financial Report (TFR); and for bank holding companies, Schedule HC-R of the Consolidated Financial Statement for Bank Holding Companies (FR Y-9C).

Amount") of ALLL attributable to the assets it excluded pursuant to the transition mechanism for risk-weighted assets. In other words, ALLL included in tier 2 capital pursuant to this transition mechanism during the Exclusion Period would not be subject to the 1.25% of risk-weighted assets limit (the "1.25% Limit") on ALLL in tier 2 capital contained in the Agencies' Risk-Based Capital Rules.

During the Phase-in Period, including for the two quarter-end regulatory report dates within the Phase-in Period, a banking organization that implemented the transition mechanism for risk-weighted assets and ALLL during the Exclusion Period may include in tier 2 capital without limit 50% of the Inclusion Amount (the "Phase-in ALLL") it included in tier 2 capital on the Measurement Date that was attributable to assets the banking organization excluded during the Exclusion Period. The remaining 50% of Phase-in ALLL, together with ALLL not attributable to consolidated VIEs to which the transition mechanism applies, may be included in tier 2 capital subject to the 1.25% Limit. As with the transition for risk-weighted assets, a banking organization may not adopt the transition mechanism for ALLL for VIEs that it must consolidate after implementing FAS 167 to which it has provided Implicit Support. Therefore, a banking organization may not include in regulatory capital ALLL beyond the 1.25% Limit that is associated with assets of a VIE to which it has provided Implicit Support.

B. Regulatory Capital Requirements Associated with the Implementation of FAS 166 and FAS 167

1. Risk-Based Capital Rules.

The Agencies refused to implement permanent modifications to the Risk-Based Capital Rules to provide an alternative risk-based capital treatment for assets that will be newly consolidated on a banking organization's balance sheet following implementation of FAS 166 and FAS 167.

In addition, despite some concern that a higher ALLL would result in higher deferred tax assets ("DTAs") and significantly affect banking organizations' regulatory capital ratios due to the Capital Rules' current limits on including DTAs and ALLL in regulatory capital, the Agencies did not modify the current limits on the inclusion of ALLL in tier 2 capital and of deferred tax assets ("DTAs") in tier 1 capital and refused to relax or eliminate the restrictions on including DTAs in tier 1 capital and ALLL in tier 2 capital to mitigate the effects of consolidation due to the implementation of FAS 167 on regulatory capital. The Agencies also noted that the current limit on DTAs that a banking organization may include in tier 1 capital is currently being considered as part of an international review of the components of regulatory capital, including deductions from capital.

2. Leverage Requirement.

The Agencies have concluded that a delay or phase-in of the effect of consolidation under FAS 167 on the Leverage Rule is not appropriate or justified because the maintenance of the Leverage Rule as a balance-sheet assessment separate from the assessment of relative risk is a particularly important feature of prudential regulation. Under the Leverage Rule, tier 1 capital is assessed against a measure of a banking organization's total on-balance sheet assets, net of ALLL and certain other exposures (the "Leverage Ratio"). Thus, previously unconsolidated assets that now must be recognized on a banking organization's balance sheet as a result of its implementation of FAS 167 will increase the denominator of the banking organization's Leverage Ratio. The Final Rule maintains the Leverage Rule as a balance-sheet assessment to supplement the Risk-Based Capital Rules and limit the degree to which a banking organization can leverage its equity capital base because the Leverage Rule (including after giving effect to the Final Rule) does not recognize the risk profile of on-balance sheet exposures, including any risk transference associated with those exposures.

C. Asset-Backed Commercial Paper Programs

Under the Final Rule, the Agencies have eliminated the ABCP Exclusion, subject to the delay and phase-in provisions described above. Thus, as with all other consolidated VIEs, a banking organization would be required to include the assets of a consolidated ABCP program in risk-weighted assets subject to the delay and phase-in provisions described above. The Final Rule also eliminates the associated provision in the general Risk-Based Capital Rules (incorporated by reference in the advanced approaches) that excludes from tier 1 capital the minority interest in a consolidated ABCP program not included in a banking organization's risk-weighted assets. The Agencies explained that the original rationale for allowing the ABCP Exclusion from risk-weighted assets that sponsoring banking organizations' risk exposure to these entities was limited to their contractual exposure no longer holds true because some banking organizations have provided Implicit Support to a number of ABCP programs they sponsored during the recent financial turmoil.

The Agencies refused to permit banks to apply the Internal Assessment Approach (the "IAA") to consolidated ABCP programs, and noted that the IAA (a) is applicable exclusively to a banking organization's exposures to off-balance sheet ABCP programs and not to a program's underlying assets when reported on balance sheet, (b) like the ABCP Exclusion, focuses on a banking organization's contractual exposures to an ABCP conduit and (c) does not capture Implicit Support and concluded that thus an extension of the IAA to consolidated ABCP programs would not sufficiently reflect the risk to sponsoring banking organizations of such programs.

D. Reservation of Authority

The Final Rule affords a new reservation of authority for the Risk-Based Capital Rules specifying that a banking organization's primary federal supervisor would have the authority to require the banking organization to treat an off-balance sheet VIE (or similar entity) as if it were consolidated onto the banking organization's balance sheet notwithstanding its GAAP treatment. The banking organization would have to hold capital against the entity's exposures for risk-based capital purposes if the primary federal supervisor determined that the banking organization's exposure or other relationship to the entity was not commensurate with the actual risk relationship of the banking organization to the entity. The Agencies stated that the reservation of authority is essential to address instances when a banking organization structures a financial transaction with a VIE to avoid consolidation under FAS 167 and the resulting capital treatment is not commensurate with all risks of the banking organization to the VIE, including non-contractual risks.