MEMORANDUM TO: Board of Directors
FROM: Christopher J. Spoth, Acting Director
Division of Supervision and Consumer Protection
SUBJECT: Advance Notice of Proposed Rulemaking Regarding
Risk-Based Capital Guidelines; Capital Maintenance: Domestic Capital
Modifications

Proposal: That the Board of Directors of the Federal Deposit Insurance Corporation (FDIC) approve the publication of the attached Advance Notice of Proposed Rulemaking regarding *Risk-Based Capital Guidelines; Capital Maintenance: Domestic Capital Modifications* (ANPR) in the Federal Register for a 90-day comment period. The ANPR would be issued on an interagency basis by the FDIC, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Office of Thrift Supervision (collectively, the Agencies). The ANPR requests comment on various modifications to the existing framework for calculating risk-based capital requirements for U.S. banking organizations. The modifications under consideration are designed to:

- Modernize the risk-based capital rules to ensure that the framework remains a relevant and reliable measure of the risks present in the banking system,
- Minimize potentially material differences in capital requirements that may arise between banks that adopt Basel II and those banks that remain under the existing rules,
- Maintain an operationally feasible capital framework that is relatively simple to implement for banking organizations subject to the existing capital rules, and
- Use currently available data to implement required changes with the intent of minimizing the burden associated with these modifications.

Recommendation: That the Board of Directors approve publication of the ANPR for a 90-day public comment period.

Concur:
William F. Kroener, III
General Counsel

I. Introduction

The FDIC Board of Directors is being asked to approve for publication in the Federal Register the attached interagency ANPR seeking comment on various modifications to the existing capital rules for the purpose of modernizing the risk-based capital framework.[1] Further, the Agencies are considering various modifications to the existing capital regulations with the intent of minimizing the potential for competitive inequities that could arise from the domestic implementation of Basel II by a limited number of large banking organizations. In addition, the Agencies believe that these various modifications would promote a greater degree of risk sensitivity and would better align capital requirements with credit risk. This initiative is being undertaken with the intent of minimizing the burden on the affected banks.

The Agencies will be guided by five general principles in the development of revisions to the existing rules. Specifically, a revised framework should (1) promote safe and sound banking practices, (2) maintain a reasonable balance between risk sensitivity and operational feasibility, (3) avoid undue regulatory burden, (4) encourage appropriate incentives and risk reduction

techniques, and (5) minimize differences in capital requirements that give rise to competitive imbalances between large and small banking organizations.

The Agencies are focusing their revisions on exposures that are common to the vast majority of the almost 9,000 banking organizations operating in the United States. On a larger scale, the agencies are considering an expansion of the existing risk bucket system as a way of developing a more robust means of calculating risk-weighted capital for credit risk. In addition, the Agencies would provide banking organizations with greater incentives for mitigating credit risk through the recognition of a broader array of collateral types and independent third-party guarantees.

The Agencies are considering various revisions to the existing capital treatment of specific asset classes, such as residential mortgage loans, externally-rated loans and securities, small business loans, and commercial real estate, and are seeking comment on a range of other exposures that will enable the agencies to develop well-constructed proposals based on relevant risk factors common to a particular business line, exposure, or bank activity. The Agencies are also considering new and revised capital requirements on defaulted assets, certain types of short-term commitments, and securitizations of revolving exposures with early amortization features to remedy shortcomings in our present capital framework.

II. Modernizing the Risk-Based Capital Rules

Consistent with our broad objective of modernizing the risk-based capital rules, the Agencies seek to advance the goal of promoting greater risk sensitivity without imposing undue burden. The Agencies identified the following areas for potential modification, as changes in these areas would be both operationally feasible and sufficiently risk sensitive to determine the appropriate capital requirements based on an institution's given level of risk:

- Increasing the number of risk-weight categories to which credit exposures may be assigned, specifically adding risk weights of 35, 75, 150, and 350 percent;
- Expanding the use of external credit ratings as an indicator of credit risk for externally-rated exposures;
- Expanding the range of collateral and guarantors that that may be recognized when applying lower weights;
- Using loan-to-value ratios and other broad measures of credit risk for assigning risk weights to residential mortgages;
- Modifying the credit conversion factor for various commitments including those with an original maturity of under one year;
- Requiring that certain loans 90 days or more past due or in non-accrual status be assigned to a higher risk-weight category;
- Modifying the risk-based capital requirements for certain commercial real estate exposures;
- Increasing the risk sensitivity of capital requirements for other types of retail, multifamily, small business, and commercial exposures; and
- Assessing a risk-based capital charge to capture the risks inherent in securitizations backed by revolving retail exposures with early amortization provisions.

III. Minimizing Competitive Inequities

The Agencies recognize the concerns raised by several institutions and trade groups in comment letters to the Basel II ANPR and in Congressional testimony regarding the potential competitive inequities that could arise between those banks that adopt a Basel II framework

(Basel II banks) and those banks that remain on the existing risk-based capital framework (general banks). Some commenters suggested that if Basel II is implemented, then further changes need to be considered to the existing capital framework to enhance its risk sensitivity and to address any competitive equity concerns associated with a bifurcated framework. The Agencies believe that these concerns warrant a thorough review and have developed this ANPR as the first step toward considering revisions to the existing capital regulations.

To assist in quantifying the effects of Basel II, the Agencies conducted a quantitative impact study during late 2004 and early 2005, commonly referred to as QIS 4. The study is a comprehensive effort completed by 26 of the largest U.S. consolidated banking organizations largely based on their own internal estimates of the key risk parameters driving the capital requirements under the Basel II framework.

The QIS-4 results (see Chart 1) provide some indication of the possible implications of a bifurcated capital framework on U.S. banking organizations. Material reductions in the minimum capital requirements conferred to one segment of the banking community could impact the operations of the remaining institutions subject to the existing rules. Specific concerns raised by institutions, trade groups and other interested parties with respect to the potential competitive inequities include:

- Loss of business opportunity as Basel II banks will have lower capital requirements that will enable them to price products lower than general banks,
- Migration of risk as general banks will have higher capital requirements and must generate likewise higher rates of return to remain competitive in the marketplace, and
- Increased levels of acquisitions of general banks by Basel II banks.

Possible modifications have been developed in those areas where competitive inequities are particularly acute and where factors used to measure the risk associated with a given product or exposure are well defined. Possible modifications for various key bank exposures are shown in the attached Chart 2. This chart also shows the estimated effect that Basel II could have on these exposures. The Agencies recognize that this ANPR represents the first attempt toward achieving greater risk sensitivity in the existing capital rules and have solicited comments that will enable us to advance a wider range of proposals covering a greater number of bank exposures in a future rulemaking.

IV. Maintaining an Operationally Feasible Framework

The existing risk-based capital rules are applied to approximately 9,000 U.S. banking organizations of varying sizes, business operations, and exposure types. As the Agencies consider more risk-sensitive capital rules that align capital with risk in a more granular fashion, consideration of multiple capital regimes appears reasonable.

The universe of banks that are not likely to adopt the advanced approaches of Basel II is still quite large and diverse. Of the institutions that are currently expected to be subject to the modified capital rules in the ANPR over the long term, 8 institutions are greater than $50 billion, 512 institutions are greater than $1 billion, and 4,045 institutions are less than $100 million in assets. (see Chart 3).

To remain competitive with Basel II banks, a more risk-sensitive capital framework will be crucial for a sizeable number of banking organizations. However, smaller banking organizations with capital ratios well above regulatory minimums may not find significant benefit in increased risk sensitivity and may find the additional requirements to be burdensome.

Consistent with our principles and objectives, the Agencies are soliciting comments in the ANPR on the implications of the proposals with respect to regulatory burden. The Agencies are also considering the feasibility of allowing certain banking organizations, especially smaller community banks and thrifts, to remain on the existing framework, thus relieving these banking organizations of any burden associated with adopting the revised capital requirements.

As required under section 2222 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA), the Agencies are requesting comments on any outdated, unnecessary, or unduly burdensome requirements in their regulatory capital rules. The Agencies specifically request comment on the extent to which any of these capital rules may adversely affect competition and whether: (1) statutory changes are necessary to eliminate specific burdensome requirements in these capital rules; (2) any of these capital rules contain requirements that are unnecessary to serve the purposes of the statute that they implement; (3) the compliance cost associated with reporting, recordkeeping, and disclosure requirements in these capital rules is justified; and (4) any of these capital rules are unclear.

Chart 1

QIS 4 Preliminary Change in Minimum Capital Requirements of Participating Institutions: Basel I to Basel II				
Portfolio	**% Change in Portfolio MRC**	**Median % Change in Port. MRC**	**Share of Basel I MRC**	**Share of Basel II MRC**
Wholesale Credit	**(25%)**	**(24%)**	**44%**	**38%**
Corporate, Bank, Sovereign	(22%)	(30%)	34%	30%
Small Business	(27%)	(27%)	5%	4%
High Volatility CRE	(33%)	(23%)	2%	1%
Incoming Producing RE	(41%)	(52%)	4%	3%
Retail Credit	**(26%)**	**(50%)**	**31%**	**26%**
Home Equity (HELOC)	(74%)	(79%)	6%	2%
Residential Mortgage	(61%)	(73%)	11%	5%
Credit Card (QRE)	66%	63%	6%	12%
Other Consumer	(7%)	(35%)	6%	6%
Retail Business Exposures	(6%)	(29%)	1%	1%
Equity	7%	(24%)	1%	2%
Other assets	(12%)	(3%)	10%	10%
Securitization	(18%)	(40%)	8%	8%
Operational Risk			0%	10%
Trading Book	0%	0%	5%	6%
Portfolio Total	(13%)	(24)%	100%	100%
Change in Effective MRC*	(15%)	(26)%		

*This is the change in the amount of Tier 1 capital and Tier 2 elements other than reserves needed to meet the minimum capital requirement.

Note:
This is data as of August 17, 2005 for the twenty-six participating QIS-4 institutions, and caution should be used in drawing any inferences from the aggregate data at this stage. The U.S. banking agencies are completing additional work to determine whether these results reflect differences in risk, reveal limitations of QIS4, identify variations in the stages of bank implementation efforts (particularly related to data availability), and/or suggest the need for adjustment to the Basel II Framework.

Chart 2

Comparison of Capital Approaches for Key Bank Exposures		
Issue	**Domestic Capital ANPR Possible Modification**	**Basel II QIS-4 Exercise Results**
Capital for corporate and sovereign debt.	Assign debt to risk weights based on external ratings	The median change to capital was a **30% decrease**. The range was a 55.7% increase to an 80.2% decrease.
Capital for residential mortgages and HELOCs	Assign mortgages and HELOCs to risk weights based on LTV ratios or on a combination LTV/credit assessment matrix	The median change to capital for residential mortgages was a **73% decrease**, with a range of a 17.8% decrease to a 98.6% decrease. The median change to capital for HELOCS was a **79% decrease**, with a range of a 91.9% increase to a 99.0% decrease.
Capital for other retail exposures (including credit cards, auto loans, etc.)	Solicit comments and suggestions and possibly assign risk weights on a combination LTV/credit assessment matrix	The median change to capital for credit cards was a **63% increase**, with a range of a 416.2% increase to a 90.4% decrease. The median change to capital for other retail exposures was a **35% decrease**, with a range of a 93.8% increase to a 97.7% decrease.
Capital for commercial real estate (CRE) exposures	Increase capital for some CRE exposures, such as acquisition, development and construction loans	The median change to capital was a **23% decrease**, with a range of a 110.3% increase to a 59.8% decrease.
Capital for other commercial exposures (such as small business lending)	Solicit comments and suggestions	The median change to capital for small business loans was a **27% decrease**, with a range of a 30.3% increase to an 80.7%.

Chart 3

Asset Size and Capital Ratios For Non-Basel II Banks* As of June 30, 2005				
Asset Size	**Number of Institutions**	**Average Total Risk-Based Capital Ratio**	**Average Tier 1 Risk-Based Capital Ratio**	**Average Leverage Ratio**
> $50 billion	8	11.70	9.53	7.31
$10 billion - $50 billion	62	14.80	13.09	8.28
$1 billion - $10 billion	450	14.26	13.02	9.36
$500 million - $1 billion	571	14.96	13.73	9.37
$250 million - $500 million	1185	15.21	14.06	9.46
$100 million - $250 million	2519	16.87	15.76	10.18
< $100 million	4045	27.30	26.21	13.51

* Defined as non-QIS 4 participants

D R A F T

DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
12 CFR Part 3
[Docket No. 04-XX]
RIN 1557- XXXX

FEDERAL RESERVE SYSTEM
12 CFR Parts 208 and 225
[Regulations H and Y; Docket No. R-XXXX]

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 325
RIN 3064-XXXX

DEPARTMENT OF THE TREASURY
Office of Thrift Supervision
12 CFR Part 567
[No. XXXX]
RIN 1550-XXXX

Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications

AGENCIES: Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Treasury.

ACTION: Joint advance notice of proposed rulemaking (ANPR).

SUMMARY: The Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), and Office of Thrift Supervision (OTS) (collectively, "the Agencies") are considering various revisions to the existing risk-based capital framework that would enhance its risk sensitivity. These changes would apply to banks, bank holding companies, and savings associations ("banking organizations"). The Agencies are soliciting comment on possible modifications to their risk-based capital standards that would facilitate the development of fuller and more comprehensive proposals applicable to a range of activities and exposures.

This ANPR discusses various modifications that would increase the number of risk-weight categories, permit greater use of external ratings as an indicator of credit risk for externally-rated exposures, expand the types of guarantees and collateral that may be recognized, and modify the risk weights associated with residential mortgages. This ANPR also discusses approaches that would change the credit conversion factor for certain types of commitments, assign a risk-based capital charge to certain securitizations with early-amortization provisions, and assign a higher risk weight to loans that are 90 days or more past due or in nonaccrual status and to certain commercial real estate exposures. The Agencies are also considering modifying the risk weights on certain other retail and commercial exposures.

DATES: Comments on this joint advance notice of proposed rulemaking must be received by [insert date [90] days after publication in the Federal Register], 2005.

ADDRESSES: Comments should be directed to:

OCC: You should include OCC and Docket Number __-___ in your comment. You may submit comments by any of the following methods:

- **Federal eRulemaking Portal:** http://www.regulations.gov. Follow the instructions for submitting comments.
- **OCC Web Site:** http://www.occ.gov. Click on "Contact the OCC," scroll down and click on "Comments on Proposed Regulations."
- **E-mail address:** regs.comments@occ.treas.gov.
- **Fax:** (202) 874-4448.
- **Mail:** Office of the Comptroller of the Currency, 250 E Street, SW., Mail Stop 1-5, Washington, DC 20219.
- **Hand Delivery/Courier:** 250 E Street, SW., Attn: Public Information Room, Mail Stop 1-5, Washington, DC 20219.

Instructions: All submissions received must include the agency name (OCC) and docket number or Regulatory Information Number (RIN) for this notice of proposed rulemaking. In general, OCC will enter all comments received into the docket without change, including any business or personal information that you provide. You may review comments and other related materials by any of the following methods:

- **Viewing Comments Personally:** You may personally inspect and photocopy comments at the OCC's Public Information Room, 250 E Street, SW, Washington, DC. You can make an appointment to inspect comments by calling (202) 874-5043.
- **Viewing Comments Electronically:** You may request e-mail or CD-ROM copies of comments that the OCC has received by contacting the OCC's Public Information Room at regs.comments@occ.treas.gov.
- **Docket:** You may also request available background documents and project summaries using the methods described above.

Board: You may submit comments, identified by Docket No. ????, by any of the following methods:

- **Agency Web Site:** http://www.federalreserve.gov. Follow the instructions for submitting comments at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm
- **Federal eRulemaking Portal:** http://www.regulations.gov. Follow the instructions for submitting comments.
- **E-mail:** regs.comments@federalreserve.gov. Include docket number in the subject line of the message.
- **FAX:** (202) 452-3819 or (202) 452-3102.
- **Mail:** Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW, Washington, DC 20551.

All public comments are available from the Board's website at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, except as

necessary for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper from in Room MP-500 of the Board's Martin Building (20th and C Street, NW) between 9:00am and 5:00pm on weekdays.

FDIC: You may submit by any of the following methods:

- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- Agency Web site: http://www.FDIC.gov/regulations/laws/federal/propose.htm
- Mail: Robert E. Feldman, Executive Secretary, Attention: Comments/Legal ESS, Federal Deposit Insurance Corporation, 550 17th Street, NW, Washington, DC 20429.
- Hand Delivered/Courier: The guard station at the rear of the 550 17th Street Building (located on F Street), on business days between 7:00 a.m. and 5:00 p.m.
- E-mail: comments@fdic.gov.
- Public Inspection: Comments may be inspected and photocopied in the FDIC Public Information Center, Room 100, 801 17th Street, NW, Washington, DC, between 9 a.m. and 4:30 p.m. on business days.

Instructions: Submissions received must include the Agency name and title for this notice. Comments received will be posted without change to http://www.FDIC.gov/regulations/laws/federal/propose.html, including any personal information provided.

OTS: You may submit comments, identified by No. 2005-XX, by any of the following methods:

- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- E-mail address: regs.comments@ots.treas.gov. Please include No. 2005-xx in the subject line of the message and include your name and telephone number in the message.
- Fax: (202) 906-6518.
- Mail: Regulation Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW, Washington, DC 20552, Attention: No. 2005-xx.
- Hand Delivery/Courier: Guard's Desk, East Lobby Entrance, 1700 G Street, NW., from 9:00 a.m. to 4:00 p.m. on business days, Attention: Regulation Comments, Chief Counsel's Office, Attention: No. 2005-xx.

Instructions: All submissions received must include the Agency name and docket number or Regulatory Information Number (RIN) for this rulemaking. All comments received will be posted without change to the OTS Internet Site at http://www.ots.treas.gov/pagehtml.cfm?catNumber=67&an=1, including any personal information provided.

Docket: For access to the docket to read background documents or comments received, go to http://www.ots.treas.gov/pagehtml.cfm?catNumber=67&an=1 . In addition, you may inspect comments at the Public Reading Room, 1700 G Street, NW, by appointment. To make an appointment for access, call (202) 906-5922, send an e-mail to public.info@ots.treas.gov, or send a facsimile transmission to (202) 906-7755. (Prior notice identifying the materials you will be requesting will assist us in serving you.) We schedule appointments on business days

between 10:00 a.m. and 4:00 p.m. In most cases, appointments will be available the next business day following the date we receive a request.

FOR FURTHER INFORMATION CONTACT:

OCC: Nancy Hunt, Risk Expert, Capital Policy Division, (202) 874-4923, Laura Goldman, Counsel, or Ron Shimabukuro, Special Counsel, Legislative and Regulatory Activities Division, (202) 874-5090, Office of the Comptroller of the Currency, 250 E Street, SW, Washington, DC 20219.

Board: Thomas R. Boemio, Senior Project Manager, Policy, (202) 452-2982, Barbara Bouchard, Deputy Associate Director, (202) 452-3072, Jodie Goff, Senior Financial Analyst, (202) 452-2818, Division of Banking Supervision and Regulation, or Mark E. Van Der Weide, Senior Counsel, (202) 452-2263, Legal Division. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), (202) 263-4869.

FDIC: William A. Stark, Associate Director, Capital Markets Branch, (202) 898-6972, Jason C. Cave, Chief, Policy Section, Capital Markets Branch, (202) 898-3548, Bobby R. Bean, Senior Quantitative Risk Analyst, Capital Markets Branch, (202) 898-3575, Division of Supervision and Consumer Protection; or Michael B. Phillips, Counsel, (202) 898-3581, Supervision and Legislation Branch, Legal Division, Federal Deposit Insurance Corporation, 550 17th Street, NW, Washington, DC 20429.

OTS: Teresa Scott, Senior Project Manager, Supervision Policy (202) 906-6478, or Karen Osterloh, Special Counsel, Regulation and Legislation Division, Chief Counsel's Office, (202) 906-6639, Office of Thrift Supervision, 1700 G Street, NW, Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

I. Background

In 1989 the Agencies implemented a risk-based capital framework for U.S. banking organizations[2] based on the "International Convergence of Capital Measurement and Capital Standards" ("Basel I" or "1988 Accord") as published by the Basel Committee on Banking Supervision ("Basel Committee").[3] Basel I addressed certain weaknesses in the various regulatory capital regimes that were in force in most of the world's major banking jurisdictions. The Basel I framework established a uniform regulatory capital system that was more sensitive to banking organizations' risk profiles than the regulatory capital to total assets ratio that was previously used in the United States, assessed regulatory capital against off-balance sheet items, minimized disincentives for banking organizations to hold low-risk assets, and encouraged institutions to strengthen their capital positions.

The Agencies' existing risk-based capital framework generally assigns each credit exposure to one of five broad categories of credit risk, which allows for only limited distinctions in credit risk for most exposures. The Agencies and the industry generally agree that the existing risk-based capital framework should be modified to better reflect the risks present in many banking organizations without imposing undue regulatory burden.

Since the implementation of the Basel I framework, the Agencies have made numerous revisions to their risk-based capital rules in response to changes in financial market practices and accounting standards. Over time, these revisions typically have increased the degree of risk sensitivity of the Agencies' risk-based capital rules. In recent years, however, the Agencies have

limited modifications to the risk-based capital framework at the domestic level and focused on the international efforts to revise the Basel I framework. In June 2004, the Basel Committee introduced a new capital adequacy framework for large, internationally-active banking organizations, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (Basel II).[4] The Basel Committee's goal was to develop a more risk sensitive capital adequacy framework for internationally-active banking organizations that generally rely on sophisticated risk management and measurement systems. Basel II is designed to create incentives for these organizations to improve their risk measurement and management processes and to better align minimum capital requirements with the risks underlying activities conducted by these banking organizations.

In August 2003, the Agencies issued an Advance Notice of Proposed Rulemaking ("Basel II ANPR"), which explained how the Agencies might implement the Basel II approach in the United States.[5] As part of the Basel II implementation process, the Agencies have been working to develop a notice of proposed rulemaking (NPR) that provides the industry with a more definitive proposal for implementing Basel II in the United States ("Basel II NPR").

The complexity and cost associated with implementing the Basel II framework effectively limit its application to those banking organizations that are able to take advantage of the economies of scale necessary to absorb these expenses. The implementation of Basel II would create a bifurcated regulatory capital framework in the United States, which may result in regulatory capital charges that differ for similar products offered by both large and small banking organizations.

In comments responding to the Basel II ANPR, Congressional testimony, and other industry communications, several banking organizations, trade associations, and others raised concerns about the competitive effects of a bifurcated regulatory framework on community and regional banking organizations. Among other broad concerns, these commenters asserted that implementing the Basel II capital regime in the United States would result in lower capital requirements for some banking organizations with respect to certain types of credit exposures. Community and regional banking organizations claimed that this would put them at a competitive disadvantage.

As part of the ongoing analysis of regulatory capital requirements, the Agencies believe that it is important to update their risk-based capital standards to enhance the risk-sensitivity of the capital charges, to reflect changes in accounting standards and financial markets, and to address competitive equity questions that, ultimately, may be raised by U.S. implementation of the Basel II framework. Accordingly, the Agencies are considering a number of revisions to their Basel I-based regulations.

To assist in quantifying the potential effects of Basel II, the Agencies conducted a quantitative impact study during late 2004 and early 2005 (QIS 4). QIS 4 was a comprehensive effort completed by 26 of the largest banking organizations using their own internal estimates of the key risk parameters driving the capital requirements under the Basel II framework. The preliminary results of QIS 4, which were released earlier this spring,[6] prompted concerns with respect to the (1) reduced levels of regulatory capital that would be required at individual banking organizations operating under the Basel II-based rules, and (2) dispersion of results among organizations and portfolio types. Because of these concerns, the issuance of a Basel II NPR was postponed while the Agencies undertook additional analytical work.[7]

The Agencies understand the desire of banking organizations to compare the proposed revisions to the existing Basel I-based capital regime with the Basel II proposal. However, the ability to definitively compare this ANPR with a Basel II NPR is limited due to the delay in the issuance of the Basel II NPR and to the number of options suggested in this ANPR. The Agencies intend to publish the pending Basel II NPR and an NPR addressing the Basel I-based rules in similar time frames, which will ultimately enable commenters to compare the proposals.

The existing risk-based capital requirements focus primarily on credit risk and generally do not impose explicit capital charges for operational or interest rate risk, which are covered implicitly by the framework. The risk-based capital charges suggested in this ANPR continue to implicitly cover aspects of these risks. Moreover, the Agencies are not proposing revisions to the existing leverage capital requirements (i.e., Tier 1 capital to total assets).[8]

II. Domestic Capital Framework Revisions

In considering revisions to their domestic risk-based capital rules the Agencies were guided by five broad principles. A revised framework must: (1) promote safe and sound banking practices and a prudent level of regulatory capital, (2) maintain a balance between risk sensitivity and operational feasibility, (3) avoid undue regulatory burden, (4) create appropriate incentives for banking organizations, and (5) mitigate material distortions in the amount of regulatory risk-based capital requirements for large and small institutions. The changes under consideration are broadly consistent with the concepts used in developing Basel II, but are tailored to the structure and activities of banking organizations operating primarily in the United States.

In this ANPR, the Agencies are considering:

- Increasing the number of risk-weight categories to which credit exposures may be assigned;
- Expanding the use of external credit ratings as an indicator of credit risk for externally-rated exposures;
- Expanding the range of collateral and guarantors that may qualify an exposure for a lower risk weight;
- Using loan-to-value ratios, credit assessments, and other broad measures of credit risk for assigning risk weights to residential mortgages;
- Modifying the credit conversion factor for various commitments, including those with an original maturity of under one year;
- Requiring that certain loans 90 days or more past due or in a non-accrual status be assigned to a higher risk-weight category;
- Modifying the risk-based capital requirements for certain commercial real estate exposures;
- Increasing the risk sensitivity of capital requirements for other types of retail, multifamily, small business, and commercial exposures; and
- Assessing a risk-based capital charge to reflect the risks in securitizations backed by revolving retail exposures with early amortization provisions.

The Agencies welcome comments on all aspects of their risk-based capital framework that might require further review and possible modification, as well as suggestions for reducing the burden of these rules. The Agencies believe that a banking organization should be able to implement any changes outlined in this ANPR using data that are currently available as part of the organization's credit approval and portfolio management processes. As a result, this

approach should minimize potential regulatory burden associated with any revisions to the existing risk-based capital rules. Commenters are particularly requested to address whether any of the proposed changes would require data that are not currently available as part of the organization's existing credit approval and portfolio management systems.

As required under section 2222 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA), the Agencies are requesting comments on any outdated, unnecessary, or unduly burdensome requirements in their regulatory capital rules. The Agencies specifically request comment on the extent to which any of these capital rules may adversely affect competition and whether: (1) statutory changes are necessary to eliminate specific burdensome requirements in these capital rules; (2) any of these capital rules contain requirements that are unnecessary to serve the purposes of the statute that they implement; (3) the compliance cost associated with reporting, recordkeeping, and disclosure requirements in these capital rules is justified; and (4) any of these capital rules are unclear.

A. Increase the Number of Risk-Weight Categories

The Agencies' risk-based capital framework currently has five risk-weight categories: zero, 20, 50, 100, and 200 percent. This limited number of risk-weight categories limits differentiation of credit quality among the individual exposures. Thus, the Agencies are considering alternatives that would better associate credit risk with an underlying exposure. One approach would be to increase the number of risk-weight categories to which on-balance sheet assets and credit equivalent amounts of off-balance sheet exposures may be assigned.

For illustrative purposes, this ANPR suggests adding four new risk-weight categories: 35, 75, 150, and 350 percent. Increasing the number of basic risk-weight categories from five to nine would permit banking organizations to redistribute exposures into additional categories of risk-weights. Like the changes in Basel II, the revisions suggested in this ANPR, such as increasing the number of risk-weight categories, should improve the risk sensitivity of the Agencies' regulatory capital rules. However, the increase in risk-weight categories is not expected to generate the same capital requirement for a given exposure as the pending Basel II proposal. The proposed categories would remain relatively broad measures of credit risk, which should minimize regulatory burden.

The Agencies seek comment on whether (1) increasing the number of risk-weight categories would allow supervisors to more closely align capital requirements with risk; (2) the additional risk-weight categories suggested above would be appropriate; (3) the risk-based capital framework should include more risk-weight categories than those proposed, such as a lower risk weight for the highest quality assets with very low historical default rates; and (4) an increased number of risk-weight categories would cause unnecessary burden on banking organizations.

B. Use of External Credit Ratings

In November 2001, the Agencies revised their risk-based capital standards to permit banking organizations to rely on external credit ratings that are publicly issued by Nationally Recognized Statistical Rating Organizations (NRSROs)[9] to assign risk weights to certain recourse obligations, direct credit substitutes, residual interests, and asset- and mortgage-backed securities.[10] For example, subject to the requirements of the rule, mortgage-backed securities with a long-term rating of AAA or AA[11] may be assigned to the 20 percent risk-weight category, and mortgage-backed securities with a long-term rating of BB may be assigned to the 200

percent risk-weight category. The rule did not apply this ratings-based approach to corporate debt and other types of exposures, even if they have an NRSRO rating.

To enhance the risk sensitivity of the risk-based capital framework, the Agencies are considering a broader use of NRSRO credit ratings to determine the risk-based capital charge for most NRSRO-rated exposures. If an exposure has multiple NRSRO ratings and these ratings differ, the credit exposure could be assigned to the risk weight applicable to the lowest NRSRO rating.

The Agencies currently are considering assigning risk weights to the rating categories in a manner similar to that presented in Tables 1 and 2.[12]

Table 1: Illustrative Risk Weights Based on External Ratings

Long-term rating category	Examples	Risk Weights
Highest two investment grade ratings	AAA/AA	20 percent
Third-highest investment grade rating	A	35 percent
Third-lowest investment grade rating	BBB+	50 percent
Second-lowest investment grade rating	BBB	75 percent
Lowest-investment grade rating	BBB-	100 percent
One category below investment grade	BB+, BB, BB-	200 percent
Two or more categories below investment grade	B and lower	350 percent

Table 2: Illustrative Risk Weights Based on Short-Term External Ratings

Short-term rating category	Examples	Risk Weights
Highest investment grade rating	A-1	20 percent
Second-highest investment grade rating	A-2	35 percent
Lowest investment grade rating	A-3	75 percent

While the Agencies are considering greater use of external ratings for determining capital requirements for a broad range of exposures, the Agencies are not planning to revise the risk weights for all rated exposures. For example, the Agencies are considering retaining the zero percent risk weight for short- and long-term U.S. government and agency exposures that are backed by the full faith and credit of the U.S. government and the 20 percent risk weight for U.S. government-sponsored entities.

The Agencies recognize that for certain exposures, the existing rules might serve as a better indicator of risk than the ratings-based approach as presented. The Recourse Final Rule introduced capital charges on sub-investment quality and unrated exposures that adequately reflect the risks associated with these exposures, which the Agencies intend to retain in their present form. Similarly, for exposures such as federal funds sold and other short-term inter-bank lending arrangements, the existing capital rules provide for a reasonable indicator of risk and thus would not be proposed to be changed. The Agencies also intend to retain the current treatment for municipal obligations. The Agencies recognize that other examples exist where the existing capital rules might serve as an appropriate indicator of risk, and request comment and suggestions on ways to accommodate these situations.

The Agencies would retain the ability to override the use of certain ratings or the ratings on certain exposures, either on a case-by-case basis or through broader supervisory policy, if necessary, to address the risk that a particular exposure poses. Furthermore, while banking organizations would be permitted to use external ratings to assign risk weights, this would not release an organization from its responsibility to comply with safety and soundness standards regarding prudent underwriting, account management, and collection policies and practices.

The Agencies solicit comment on (1) whether the risk-weight categories for NRSRO ratings are appropriately risk sensitive, (2) the amount of any additional burden that this approach might generate, especially for community banking organizations, in comparison with the benefit that such organizations would derive, (3) the use of other methodologies that might be reasonably employed to assign risk weights for rated exposures, and (4) methodologies that might be used to assign risk weights to unrated exposures.

C. Expand Recognized Financial Collateral and Guarantors

i. Recognized Financial Collateral

The Agencies' risk-based capital framework permits lower risk weights for exposures protected by certain types of eligible financial collateral. Generally, the only forms of collateral that the Agencies' existing rules recognize are cash on deposit at the banking organization; securities issued or guaranteed by central governments of the OECD countries, U.S. government agencies, and U.S. government-sponsored enterprises; and securities issued by multilateral lending institutions or regional development banks.[13] If an exposure is partially secured, the portion of the exposure that is covered by collateral generally may receive the risk weight associated with the collateral, and the portion of the exposure that is not covered by the collateral is assigned to the risk-weight category applicable to the obligor or the guarantor.

The banking industry has commented that the Agencies should recognize the risk mitigation provided by a broader array of collateral types for purposes of determining a banking organization's risk-based capital requirements. The Agencies believe that recognizing additional risk mitigation techniques would increase the risk sensitivity of their risk-based capital standards in a manner generally consistent with market practice and would provide greater incentives for better credit risk management practices.

The Agencies are considering expanding the list of recognized collateral to include short- or long-term debt securities (for example, corporate and asset- and mortgage-backed securities) that are externally-rated at least investment grade by a NRSRO, or issued or guaranteed by a sovereign central government that is externally-rated at least investment grade by an NRSRO. The NRSRO-rated debt securities would be assigned to the risk-weight category appropriate to the external credit rating as discussed in section II.B of this ANPR. For example, the portion of an exposure collateralized by an AAA- or AA-rated corporate security could be assigned to the 20 percent risk-weight category. Similarly, portions of exposures collateralized by financial collateral would be assigned to risk-weight categories based on the external rating of that collateral.

To use this expanded list of collateral, banking organizations would be required to have collateral management systems that can track collateral and readily determine the value of the collateral that the banking organization would be able to realize. The Agencies are

seeking comments on whether this approach for expanding the scope of eligible collateral improves risk sensitivity without being overly burdensome.

ii. Eligible Guarantors

Under the Agencies' risk-based capital framework there is only limited recognition of guarantees provided by independent third parties. Specifically, the risk-based capital standards assign lower risk weights to exposures that are guaranteed by the central government of an OECD country, U.S. government agencies, U.S. government-sponsored enterprises, municipalities, public sector entities in OECD countries, multilateral lending institutions and regional development banks, depository institutions incorporated in OECD countries, qualifying securities firms, short-term exposures of depository institutions incorporated in non-OECD countries, and local currency exposures of central governments of non-OECD countries.

The Agencies seek comment on expanding the scope of recognized guarantors to include any entity whose long-term senior debt has been assigned an external credit rating of at least investment grade by an NRSRO. The applicable risk weight for the guaranteed exposure could be based on the risk weights in Tables 1 and 2. This approach would eliminate the distinction between OECD and non-OECD countries. The Agencies are also seeking comments on using a ratings-based approach for determining the risk weight applicable to a recognized guarantor and, more specifically, limiting the external rating for a recognized guarantor to investment grade or above.

D. One-to-Four Family Mortgages: First and Second Liens

Under the existing rules, most one-to-four family mortgages that are first liens are generally eligible for a 50 percent risk weight. Industry participants have, for some time, asserted that this 50 percent risk weight imposes an excessive risk-based capital requirement for many of these exposures. The Agencies observe that this "one size fits all" approach to risk-based capital may not assess suitable levels of capital for either low- or high-risk mortgage loans. Therefore, to align risk-based capital requirements more closely with risk, the Agencies are considering possible options for changing their risk-based capital requirements for first lien one-to-four family residential mortgages.

Several industry participants have suggested that capital requirements for first lien one-to-four family mortgages could be based on collateral through the use of the loan-to-value ratio (LTV). The following table illustrates one approach for using LTV ratios to determine risk-based capital requirements:

Table 3: Illustrative Risk Weights for One-to-Four Family Residential Mortgages (after consideration of PMI)

LTV Ratio	Risk Weight
91-100	100%
81-90	50%
61-80	35%
<60	20%

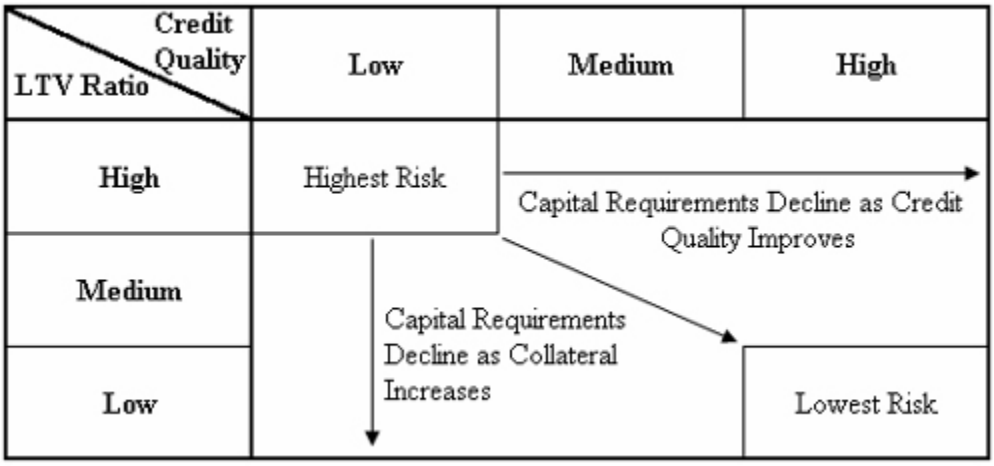
Basing risk weights on LTVs in a manner similar to that illustrated above is intended to improve the risk sensitivity of the existing risk-based capital framework. The Agencies believe that the use of LTV ratios to measure risk sensitivity would not increase regulatory burden for banking organizations since this data is readily available and is often utilized in the loan approval process and in managing mortgage portfolios.

Banking organizations would determine the LTV of a mortgage loan after consideration of loan-level private mortgage insurance (PMI) provided by an insurer with an NRSRO-issued long-term debt rating of single A or higher. However, the Agencies currently do not recognize portfolio or pool-level PMI for purposes of determining the LTV of an individual mortgage. Furthermore, the Agencies note that reliance on even a highly-rated PMI insurance provider has some measure of counterparty credit risk and that PMI contract provisions vary, which provides banking organizations with a range of alternatives for mitigating credit risk. Arrangements that require a banking organization to absorb any amount of loss before the PMI provider would not be recognized under this approach. In addition, the Agencies are concerned that a blanket acceptance of PMI might overstate its ability to effectively mitigate risk especially on higher risk loans and novel products. Accordingly, to address concerns about PMI, the Agencies could place risk-weight floors on mortgages that are subject to PMI.

The Agencies seek comment on (1) the use of LTV to determine risk weights for first lien one-to-four family residential mortgages, (2) whether LTVs should be updated periodically, (3) whether loan-level or portfolio PMI should be used to reduce LTV ratios for the purposes of determining capital requirements, (4) alternative approaches that are sensitive to the counterparty credit risk associated with PMI, and (5) risk-weight floors for certain mortgages subject to PMI, especially higher-risk loans and novel products.

The Agencies are also considering alternative methods for assessing capital based on the evaluation of credit risk for borrowers of first lien one-to-four family mortgages. For example, credit assessments, such as credit scores, might be combined with LTV ratios to determine risk-based capital requirements. Under this scenario, different ranges of LTV ratios could be paired with specified ranges of credit assessments. Based on the resulting risk assessments, the Agencies could assign mortgage loans to specific risk-weight categories. Table 4 illustrates one approach for pairing LTV ratios with a borrower’s credit assessment. As the table indicates, risk decreases as the LTV decreases and the borrower's credit assessment increases, which results in a decrease in capital requirements. Mortgages with low LTVs that are written to borrowers with higher credit worthiness might receive lower risk weights than reflected in Table 3; conversely, mortgages with high LTVs written to borrowers with lower credit worthiness might receive higher risk weights.

Table 4: Conceptual Approach for Determining Risk Weights: Residential Mortgages Based on LTV Ratios and Credit Assessments



Another parameter that could be combined with LTV ratios to determine capital requirements might be a capacity measure such as a debt-to-income ratio. The Agencies seek comment on (1) the use of an assessment mechanism based on LTV ratios in combination with credit assessments, debt-to-income ratios, or other relevant measures of credit quality, (2) the impact of the use of credit scores on the availability of credit or prices for lower income borrowers, and (3) whether LTVs and other measures of creditworthiness should be updated annually or quarterly and how these parameters might be updated to accurately reflect the changing risk of a mortgage loan as it matures and as property values and borrower's credit assessments fluctuate.

The Agencies are interested in any specific comments and available data on non-traditional mortgage products (e.g., interest-only mortgages). In particular, the Agencies are reviewing the recent rapid growth in mortgages that permit negative amortization, do not amortize at all, or have an LTV greater than 100 percent. The Agencies seek comment on whether these products should be treated in the same matrix as traditional mortgages or whether such products pose unique and perhaps greater risks that warrant a higher risk-based capital requirement.

If a banking organization holds both a first and a second lien, including a home equity line of credit (HELOC), and no other party holds an intervening lien, the Agencies' existing capital rules permit these loans to be combined to determine the LTV and the appropriate risk weight as if it were a first lien mortgage. The Agencies intend to continue to permit this approach for determining LTVs.

For stand-alone second lien mortgages and HELOCs, where the institution holds a second lien mortgage but does not hold the first lien mortgage and the LTV at origination (original LTV) for the combined loans does not exceed 90 percent, the Agencies are considering retaining the current 100 percent risk weight. For second liens, where the original LTV of the combined liens exceeds 90 percent, the Agencies believe that a risk weight higher than 100 percent would be appropriate in recognition of the credit risk associated with these exposures. The Agencies seek comment regarding this approach.

E. Multifamily Residential Mortgages

Under the Agencies' existing rules, multifamily (i.e., properties with more than four units) residential mortgages are generally risk-weighted at 100 percent. Certain seasoned multifamily residential loans may, however, qualify for a risk weight of 50 percent.[14] The Agencies seek comment and request any available data that might demonstrate that all multifamily loans or specific types of multifamily loans that meet certain criteria, for example, small size, history of performance, or low loan-to-value ratio, should be eligible for a lower risk weight than is currently permitted in the Agencies' rules.

F. Other Retail Exposures

Banking organizations also hold many other types of retail exposures, such as consumer loans, credit cards, and automobile loans. The Agencies are considering modifying the risk-based capital rules for these other retail exposures and are seeking information on alternatives for structuring a risk-sensitive approach based on well-known and relevant risk drivers as the basis for the capital requirement. One approach that would increase the credit risk sensitivity of the risk-based capital requirements for other retail exposures would be to use a credit assessment, such as the borrower's credit score or ability to service debt.

The Agencies request comment on any methods that would accomplish their goal of increasing risk sensitivity without creating undue burden, and, more specifically, on what risk drivers (for example, LTV, credit assessments, and/or collateral) and risk weights would be appropriate for these types of loans. The Agencies further request comment on the impact of the use of any recommended risk drivers on the availability of credit or prices for lower-income borrowers.

G. Short-Term Commitments

Under the Agencies' risk-based capital standards, short-term commitments (with the exception of short-term liquidity facilities providing liquidity support to asset-backed commercial paper (ABCP) programs)[15] are converted to an on-balance sheet credit equivalent amount using the zero percent credit conversion factor (CCF). As a result, banking organizations that extend short-term commitments do not hold any risk-based capital against the credit risk inherent in these exposures. By contrast, commitments with an original maturity of greater than one year are generally converted to an on-balance sheet credit equivalent amount using the 50 percent CCF.

The Agencies are considering amending their risk-based capital requirements for commitments with an original maturity of one year or less (i.e., short-term commitments). Even though commitments with an original maturity of one year or less expose banking organizations to a lower degree of credit risk than longer-term commitments, some credit risk exists. The Agencies are considering whether this credit risk should be reflected in the risk-based capital requirement. Thus, the Agencies are considering applying a 10 percent CCF on certain short-term commitments. The resulting credit equivalent amount would then be risk-weighted according to the underlying assets or the obligor, after considering any collateral, guarantees, or external credit ratings.

Commitments that are unconditionally cancelable at any time, in accordance with applicable law, by a banking organization without prior notice, or that effectively provide for automatic

cancellation due to deterioration in a borrower's credit assessment would continue to be eligible for a zero percent CCF.[16]

The Agencies solicit comment on the approach for short-term commitments as discussed above. Further, the Agencies seek comment on an alternative approach that would apply a single CCF (for example, 20 percent) to all commitments, both short-term and long-term.

H. Loans 90 Days or More Past Due or in Nonaccrual

Under the existing risk-based capital rules, loans generally are risk-weighted at 100 percent unless the credit risk is mitigated by an acceptable guarantee or collateral. When exposures (for example, loans, leases, debt securities, and other assets) reach 90 days or more past due or are in nonaccrual status, there is a high probability that the financial institution will incur a loss. To address this potentially higher risk of loss, the Agencies are considering assigning exposures that are 90 days or more past due and those in nonaccrual status to a higher risk-weight category. However, the amount of the exposure to be assigned to the higher risk-weight category may be reduced by any reserves directly allocated to cover potential losses on that exposure. The Agencies seek comments on all aspects of this potential change in treatment.

I. Commercial Real Estate (CRE) Exposures

The Agencies are may revise the capital requirements for certain commercial real estate exposures such as acquisition, development and construction (ADC) loans based on longstanding supervisory concerns with many of these loans. The Agencies are considering assigning certain ADC loans to a higher than 100 percent risk weight. However, the Agencies recognize that a "one size fits all" approach to ADC lending might not be risk sensitive, and could discourage banking organizations from making ADC loans backed by substantial borrower equity. Therefore, the Agencies are considering exempting ADC loans from the higher risk weight if the ADC exposure meets the Interagency Real Estate Lending Standards regulations[17] and the project is supported by a substantial amount of borrower equity for the duration of the facility (e.g., 15 percent of the completion value in cash and liquid assets). Under this approach, ADC loans satisfying these standards would continue to be assigned to the 100 percent risk-weight category.

The Agencies seek recommendations on improvements to these standards that would result in prudent capital requirements for ADC loans while not creating undue burden for banking organizations making such loans. The Agencies also seek comments on alternative ways to make risk weights for commercial real estate loans more risk sensitive. To that end, they request comments on what types of risk drivers, like LTV ratios or credit assessments, could be used to differentiate among the credit qualities of commercial real estate loans, and how the risk drivers could be used to determine risk weights.

J. Small Business Loans

Under the Agencies' risk-based capital rules, a small business loan is generally assigned to the 100 percent risk-weight category unless the credit risk is mitigated by an acceptable guarantee or collateral. Banking institutions and other industry participants have criticized the lack of risk sensitivity in the risk-based capital charges for these exposures. To improve the risk sensitivity of their capital rules, the Agencies are considering a lower risk weight for certain business loans under $1 million on a consolidated basis to a single borrower.

Under one alternative, to be eligible for a lower risk weight, the small business loan would have to meet certain requirements: full amortization over a period of seven years or less, performance according to the contractual provisions of the loan agreement, and full protection by collateral. The banking organization would also have to originate the loan according to its underwriting policies (or purchase a loan that has been underwritten in a manner consistent with the banking organization's underwriting policies), which would have to include an acceptable assessment of the collateral and the borrower's financial condition and ability to repay the debt. The Agencies believe that under these circumstances the risk weight of a small business loan could be lowered to, for example, 75 percent. The Agencies seek comment on whether this relatively simple change would improve the risk sensitivity without unduly increasing complexity and burden.

Another alternative would be to assess risk-based capital based on a credit assessment of the business' principals and their ability to service the debt. This alternative could be applied in those cases where the business principals personally guarantee the loan.

The Agencies seek comment on any alternative approaches for improving risk sensitivity of the risk-based capital treatment for small business loans, including the use of credit assessments, LTVs, collateral, guarantees, or other methods for stratifying credit risk.

K. Early Amortization

Currently, there is no risk-based capital charge against risks associated with early amortization of securitizations of revolving credits (e.g., credit cards). When assets are securitized, the extent to which the selling or sponsoring entity transfers the risks associated with the assets depends on the structure of the securitization and the nature of the underlying assets. The early amortization provision in securitizations of revolving retail credit facilities increases the likelihood that investors will be repaid before being subject to any risk of significant credit losses.

Early amortization provisions raise several distinct concerns about the risks to seller banking organizations: (1) the subordination of the seller’s interest in the securitized assets during early amortization to the payment allocation formula, (2) potential liquidity problems for selling organizations, and (3) incentives for the seller to provide implicit support to the securitization transaction -- credit enhancement beyond any pre-existing contractual obligations -- to prevent early amortization. The Agencies have proposed the imposition of a capital charge on securitizations of revolving credit exposures with early amortization provisions in prior rulemakings. On March 8, 2000, the Agencies published a proposed rule on recourse and direct credit substitutes (Proposed Recourse Rule).[18] In that proposal, the Agencies proposed to apply a fixed conversion factor of 20 percent to the amount of assets under management in all revolving securitizations that contained early amortization features in recognition of the risks associated with these structures.[19] The preamble to the Recourse Final Rule,[20] reiterated the concerns with early amortization, indicating that the risks associated with securitization, including those posed by an early amortization feature, are not fully captured in the Agencies’ capital rules. While the Agencies did not impose an early amortization capital charge in the Recourse Final Rule, they indicated that they would undertake a comprehensive assessment of the risks imposed by early amortization.[21]

The Agencies acknowledge that early amortization events are infrequent. Nonetheless, an increasing number of securitizations have been forced to unwind and repay investors earlier than planned. Accordingly, the Agencies are considering assessing risk-based capital against

securitizations of personal and business credit card accounts. The Agencies are also considering the appropriateness of applying an early amortization capital charge to securitizations of revolving credit exposures other than credit cards, and request comment on this issue.

One option would be to assess a flat conversion factor, (e.g., 10 percent) against off-balance sheet receivables in securitizations with early amortization provisions. Another approach that would potentially be more risk-sensitive would be to assess capital against these types of securitizations based on key indicators of risk, such as excess spread levels. Virtually all securitizations of revolving retail credit facilities that include early amortization provisions rely on excess spread as an early amortization trigger. Early amortization generally commences once excess spread falls below zero for a given period of time.

Such a capital charge would be assessed against the off-balance sheet investors' interest and would be imposed only in the event that the excess spread has declined to a predetermined level. The capital requirement would assess increasing amounts of risk-based capital as the level of excess spread approaches the early amortization trigger (typically, a three-month average excess spread of zero). Therefore, as the probability of an early amortization event increases, the capital charge against the off-balance sheet portion of the securitization also would increase.

The Agencies are considering comparing the three-month average excess spread against the point at which the securitization trust would be required by the securitization documents to trap excess spread in a spread or reserve account as a basis for a capital charge. Where a transaction does not require excess spread to be trapped, the trapping point would be 4.5 percentage points. In order to determine the appropriate conversion factor, a bank would divide the level of excess spread by the spread trapping point.

Table 5: Example of Credit Conversion Factor Assignment by Segment

3-month average excess spread	Credit Conversion Factor (CCF)
133.33 percent of trapping point or more	0 percent
less than 133.33 percent to 100 percent of trapping point	5 percent
less than 100 percent to 75 percent of trapping point	15 percent
less than 75 percent to 50 percent of trapping point	50 percent
less than 50 percent of trapping point	100 percent

The Agencies seek comment on whether to adopt either alternative treatment of securitizations of revolving credit facilities containing early amortization mechanisms and whether either treatment satisfactorily addresses the potential risks such transactions pose to originators. The Agencies also seek comment on whether other early amortization triggers exist that might have to be factored into such an approach, e.g., level of delinquencies, and whether there are other approaches, treatments, or factors that the Agencies should consider.

III. Application of the Proposed Revisions

The Agencies are aware that some banking organizations may prefer to remain under the existing risk-based capital framework without revision. The Agencies are considering the

possibility of permitting some banking organizations to elect to continue to use the existing risk-based capital framework, or portions thereof, for determining minimum risk-based capital requirements so long as that approach remains consistent with safety and soundness. The Agencies seek comment on whether there is an asset size threshold below which banking organizations should be allowed to apply the existing risk-based capital framework without revision.

The Agencies are also considering allowing banking organizations to choose among alternative approaches for some of the modifications to the existing capital rules that may be proposed. For example, a banking organization might be permitted to risk-weight all prudently underwritten mortgages at 50 percent if that organization chose to forgo the option of using potentially lower risk weights for its residential mortgages based on LTV or some other approach that may be proposed. The Agencies seek comment on the merits of this type of approach.

Finally, the Agencies note that, under Basel II, banking organizations are subject to a transitional capital floor (that is, a limit on the amount by which risk-based capital could decline). In the pending Basel II NPR, the Agencies expect to seek comment on how the capital floor should be defined and implemented. To the extent that revisions result from this ANPR process, the Agencies seek commenters' views on whether the revisions should be incorporated into the definition of the Basel II capital floor.

IV. Reporting Requirements

The Agencies believe that risk-based capital levels for most banks should be readily determined from data supplied in the quarterly Call and Thrift Financial Report filings. Accordingly, modifications to the Call and Thrift Financial Reports will be necessary to track the agreed-upon risk factors used in determining risk-based capital requirements. For example, banking organizations would be expected to segment residential mortgages into ranges based on the LTV ratio if that factor were used in determining a loan’s capital charge. Externally-rated exposures could be segmented by the rating assigned by the NRSRO. Additionally, all organizations would need to provide more detail on guaranteed and collateralized exposures.

The Agencies seek comment on the various alternatives available to balance the need for enhanced reporting and greater transparency of the risk-based capital calculation, with the possible burdens associated with such an effort.

V. Regulatory Analysis

Federal agencies are required to consider the costs, benefits, or other effects of their regulations for various purposes described by statute or executive order. This section asks for comment and information to assist OCC and OTS in their analysis under Executive Order 12866.[22] Executive Order 12866 requires preparation of an analysis for agency actions that are "significant regulatory actions." "Significant regulatory actions" include, among other things, regulations that "have an annual effect on the economy of $ 100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or state, local, or tribal governments or communities. * * *"[23] Regulatory actions that satisfy one or more of these criteria are called "economically significant regulatory actions."

If OCC or OTS determines that the rules implementing the domestic capital modifications comprise an "economically significant regulatory action," then the agency making that

determination would be required to prepare and submit to the Office of Management and Budget's (OMB) Office of Information and Regulatory Affairs (OIRA) an economic analysis. The economic analysis must include:

- A description of the need for the rules and an explanation of how they will meet the need;
- An assessment of the benefits anticipated from the rules (for example, the promotion of the efficient functioning of the economy and private markets) together with, to the extent feasible, a quantification of those benefits;
- An assessment of the costs anticipated from the rules (for example, the direct cost both to the government in administering the regulation and to businesses and others in complying with the regulation, and any adverse effects on the efficient functioning of the economy, private markets (including productivity, employment, and competitiveness)), together with, to the extent feasible, a quantification of those costs; and
- An assessment of the costs and benefits of potentially effective and reasonably feasible alternatives to the planned regulation (including improving the current regulation and reasonably viable nonregulatory actions), and an explanation why the planned regulatory action is preferable to the identified potential alternatives.[24]

For purposes of determining whether this rulemaking would constitute an "economically significant regulatory action," as defined by E.O. 12866, and to assist any economic analysis that E.O. 12866 may require, OCC and OTS encourage commenters to provide information about:

- The direct and indirect costs of compliance with the revisions described in this ANPR;
- The effects of these revisions on regulatory capital requirements;
- The effects of these revisions on competition among banks; and
- The economic benefits of the revisions, such as the economic benefits of a potentially more efficient allocation of capital that might result from revisions to the current risk-based capital requirements.

OCC and OTS also encourage comment on any alternatives to the revisions described in this ANPR that the Agencies should consider. Specifically, commenters are encouraged to provide information addressing the direct and indirect costs of compliance with the alternative, the effects of the alternative on regulatory capital requirements, the effects of the alternative on competition, and the economic benefits from the alternative.

Quantitative information would be the most useful to the Agencies. However, commenters may also provide estimates of costs, benefits, or other effects, or any other information they believe would be useful to the Agencies in making the determination. In addition, commenters are asked to identify or estimate start-up, or non-recurring, costs separately from costs or effects they believe would be ongoing.

[1] The Agencies are considering the domestic implementation of the advanced approaches for determining minimum risk-based capital requirements for credit and operational risk as described in the Basel Committee on Banking Supervision's "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (Basel II). The complete text for Basel II is available on the Bank for International Settlements Web site at http://www.bis.org. For the proposed domestic implementation of Basel II, see the Basel II ANPR, 68 FR 45900 (August 4, 2003).

[2] See 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 (OTS). The risk-based capital rules generally do not apply to bank holding companies with less than $150 million in assets. On September 8, 2005, the Board issued a proposal that generally would raise this exclusion amount to $500 million. (See 70 FR 53320.) The comment period will end on November 11, 2005.

[3] The Basel Committee on Banking Supervision was established in 1974 by central banks and authorities with bank supervisory responsibilities. Current member countries are Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

[4] The complete text for Basel II is available on the Bank for International Settlements Web site at http://www.bis.org.

[5] As stated in its preamble, the Basel II ANPR was based on a consultation document entitled "The New Basel Capital Accord" that was published by the Basel Committee on April 29, 2003 for public comment. The Basel II ANPR anticipated the issuance of a final revised accord. The ANPR identified the United States banking organizations that would be subject to this new capital regime ("Basel II banks") as those: (1) with total banking assets in excess of $250 billion or on-balance sheet foreign exposures in excess of $10 billion, and (2) that choose to voluntarily apply Basel II. See 68 FR 45900 (Aug. 4, 2003). For credit risk, Basel II includes three approaches for regulatory capital: standardized, foundation internal ratings-based, and the advanced internal ratings-based. For operational risk, Basel II also includes three methodologies: basic indicator, standardized, and advanced measurement. The Basel II ANPR focused only on the advanced internal ratings-based and the advanced measurement approaches.

[6] See Testimony before the Subcommittee on Financial Institutions and Consumer Credit and the Subcommittee on Domestic and International Monetary Policy, Trade and Technology of the Committee on Financial Services, United States House of Representatives, May 11, 2005. The testimony is available at http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=383 . The specific numbers from the QIS 4 survey are currently under review.

[7] See interagency press release dated April 29, 2005.

[8] See 12 CFR 3.6(b) and (c) (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).

[9] A NRSRO is an entity recognized by the Division of Market Regulation of the Securities and Exchange Commission (SEC) as a nationally recognized statistical rating organization for various purposes, including the SEC's uniform net capital requirements for brokers and dealers.

[10] Final Rule to Amend the Regulatory Capital Treatment of Recourse Arrangements, Direct Credit Substitutes, Residual Interests in Asset Securitizations, and Asset-Backed and Mortgage-Backed Securities (Recourse Final Rule), 66 FR 59614 (November 29, 2001).

[11] The rating designations (e.g., "AAA," "BBB", and "A1") used in this ANPR are illustrative only and do not indicate any preference for, or endorsement of, any particular rating agency designation system.

[12] As more fully discussed in Section C of this ANPR, the Agencies are also considering using these tables to risk weight an exposure that is collateralized by debt that has an external rating issued by a NRSRO or that is guaranteed by an entity whose senior long-term debt has an external credit rating assigned by an NRSRO.

[13] The Agencies' rules, however, differ somewhat as is described in the Agencies' joint report to Congress. See "Joint Report: Differences in Accounting and Capital Standards among the Federal Banking Agencies", 57 FR 15379 (March 25, 2005). The Agencies intend to eliminate these differences in their respective risk-based capital regulations relating to collateralized exposures. This approach would result in consistent rules governing collateralized transactions in all material respects among the Agencies.

[14] To qualify, these loans must meet various requirements for amortization schedules, minimum maturity, LTV, and other requirements. See 12 CFR part 3, appendix A, § 3(a)(3)(v) (OCC); 12 CFR parts 208 and 225, appendix A, § III.C.3 (Board); 12 CFR part 325, appendix A, § II.C (category 3 – 50 percent risk weight) (FDIC); 12 CFR 567.1 (OTS).

[15] Unused portions of short-term ABCP liquidity facilities are assigned a 10 percent credit conversion factor. See 69 FR 44908 (July 28, 2004).

[16] For example, the CCF for unconditionally cancelable commitments related to unused portions of retail credit card lines would remain at zero percent. 12 CFR part 3, appendix A, § 3(b)(4)(iii) (OCC); 12 CFR parts 208 and 225, appendix A, § III.D.5 (Board) 12 CFR part 325, appendix A, § II.D.5 (FDIC); 12 CFR 567.6(a)(2)(v)(C) (OTS).

[17] See 12 CFR part 34, subpart D (OCC); 12 CFR part 208, subpart E, appendix C (Board); 12 CFR part 365 (FDIC); 12 CFR 560.100-101 (OTS).

[18] 65 FR 12320 (March 8, 2000).

[19] Id. at 12330-31.

[20] 66 FR 59614, 59619 (November 29, 2001).

[21] In October 2003, the Agencies issued another proposed rule that included a risk-based capital charge for early amortization. See 68 FR 56568j, 56571-73 (October 1, 2003). This proposal was based upon the Basel Committee's third consultative paper issued April 2003. When the Agencies finalized other unrelated aspects of this proposed rule in July 2004, they did

not implement the early amortization proposal. The Agencies determined that the change was inappropriate because the capital treatment of retail credit, including securitizations of revolving credit, was subject to change as the Basel framework proceeded through the United States rulemaking process. The Agencies, however, indicated that they would revisit the domestic implementation of this issue in the future. 69 FR 44908, 44912-13 (July 28, 2004).

[22] E.O. 12866 applies to OCC and OTS, but not the Board or the FDIC.

[23] Executive Order 12866 (September 30, 1993), 58 FR 51735 (October 4, 1993), as amended by Executive Order 13258, 67 FR 9385. For the complete text of the definition of "significant regulatory action," see E.O. 12866 at § 3(f). A "regulatory action" is "any substantive action by an agency (normally published in the Federal Register) that promulgates or is expected to lead to the promulgation of a final rule or regulation, including notices of inquiry, advance notices of proposed rulemaking, and notices of proposed rulemaking." E.O. 12866 at 3§ (e).

[24] The components of the economic analysis are set forth in E.O. 12866 § 6(a)(3)(C)(i)-(iii). For a description of the methodology that OMB recommends for preparing an economic analysis, see Office of Management and Budget Circular A-4, "Regulatory Analysis" (September 17, 2003). This publication is available on OMB's Web site at http://www.whitehouse.gov/omb/circulars/a004/a-4.pdf 549k (PDF Help).