

MODIFICATIONS TO THE RISK-BASED CAPITAL REGULATIONS
Advance Notice of Proposed Rulemaking

The Board of Directors of the Federal Deposit Insurance Corporation (FDIC) approved the publication of an Advance Notice of Proposed Rulemaking (ANPR) on October 6, 2005, that considers a range of approaches for enhancing the risk sensitivity of the current risk-based capital framework. The ANPR is being 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 (the agencies) for a 90-day comment period. Comments are due by January 18, 2005.

The proposals under consideration could affect virtually all FDIC-supervised institutions. Institutions should closely review the attached document, which includes various alternatives to the current rules, and provide specific comments that will enable the agencies to advance fully developed proposals in a future rulemaking.

The agencies have developed high-level principles that define the objectives of the domestic capital rulemaking. These principles are:

- Address potential competitive inequities between the existing risk-based capital framework and the proposed domestic implementation of the risk-based capital framework described in “International Convergence of Capital Measurement and Capital Standards: A Revised Framework” (Basel II);¹
- Modernize the risk-based capital rules to recognize advances made within the banking industry in the areas of credit risk measurement and mitigation; and
- Ensure that the revised framework is well suited for the approximately 9,000 banking organizations of varying asset sizes and capital levels without creating undue burden.

Addressing Potential Competitive Inequities. The FDIC recognizes the concerns raised by several institutions and trade groups regarding the potential competitive inequities that could arise between banks that adopt a Basel II framework and those that remain on the existing risk-based capital framework. Institutions are urged to analyze and compare the proposals set forth in the ANPR with the Basel II approaches currently under consideration for implementation in the United States, which are the advanced

¹ 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).

internal ratings-based approach for credit risk and the advanced measurement approach for operational risk.

To facilitate comment on the competitive aspects of these two capital frameworks, the FDIC has included in this letter selected results of the fourth quantitative impact study of Basel II (QIS-4) conducted by 26 large U.S. banking organizations. The QIS-4 results provide some perspective on the possible competitive issues that could arise between Basel II banks and those banks that will remain subject to the existing risk-based capital rules (see Chart 1). The QIS-4 results suggest that risk-based capital requirements for all major lending categories, except credit cards, would be substantially less than current requirements and possibly the requirements discussed in this ANPR.

The ANPR proposes modifications to the existing risk-based capital rules where quantitative factors used to measure the risk associated with a given product or exposure can be readily articulated. However, in certain areas the ANPR may not adequately address potential competitive inequities, especially where risk-measurement factors are not well defined or universally applied, such as with unrated commercial loans and certain retail loans. The FDIC encourages comments in those areas.

Modernizing the Risk-Based Capital Rules. The agencies seek to advance the goal of promoting greater risk sensitivity without imposing undue burden and have identified the following areas for potential modification:

- 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 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.

Ensuring the Revised Risk-Based Capital Framework Is Well Suited for All Applicable Banks. The FDIC recognizes that the proposals under consideration might not be suitable to the entire universe of institutions that will most likely not adopt the Basel II approaches. Institutions vary considerably in size and capital levels. Some

institutions may be more inclined to remain on the existing risk-based capital framework rather than adopt a more risk-sensitive framework.

The FDIC encourages all commenters to carefully consider the implications of the proposals included in the ANPR. In addition to comments on the specific proposals set forth in the ANPR, the FDIC welcomes any alternatives or suggestions that would facilitate the development of fuller and more comprehensive proposals applicable to a range of activities and exposures. Finally, as required under section 2222 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA), the ANPR solicits comments on any outdated, unnecessary, or unduly burdensome requirements in the regulatory capital rules.

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