

# Clients & Friends Memo

## Proposed Changes in U.S. Bank Capital Regulations

October 14, 2005

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, "the Agencies") have jointly issued an advance notice of proposed rulemaking (the "ANPR") that discusses various proposed revisions to the existing U.S. risk-based capital framework 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. The 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 have indicated that they are also considering modifying the risk weights on certain other retail and commercial exposures. These changes would apply to banks, bank holding companies, and savings associations ("banking organizations"). This Memorandum summarizes the principal provisions of the ANPR.

The Agencies have requested comment regarding the proposals contained in the ANPR and will accept comments until the ninetieth (90<sup>th</sup>) day following the publication of the ANPR in the Federal Register.

### Executive Summary

The Agencies have requested comments regarding the following proposed changes to the existing U.S. risk-based capital framework:

- 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.

### **Specific Proposals**

#### 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.

The ANPR suggests adding four new risk weight categories: 35, 75, 150, and 350 percent, which would be applied to exposures with the respective credit qualities referenced in section "B" below.

The Agencies have requested 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 (NRSRO's)<sup>1</sup> to assign risk weights to certain recourse obligations, direct credit substitutes, residual interests, and asset- and mortgage- backed securities.<sup>2</sup> The rule did

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<sup>1</sup> 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.

<sup>2</sup> 66 FR 59624 (November 29, 2001).

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.<sup>3</sup>

**Table 1: Illustrative Risk Weights Based on External Ratings**

<u>Long-term rating category</u>	<u>Examples</u>	<u>Risk Weights</u>
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**

<u>Long-term rating category</u>	<u>Examples</u>	<u>Risk Weights</u>
Highest two investment grade ratings	A-1	20 percent
Second-highest investment grade rating	A-2	35 percent
Lowest-investment grade rating	A-3	75 percent

<sup>3</sup> As more fully discussed in section C below, 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.

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 also intend to retain (i) existing rules regarding capital charges on sub-investment quality and unrated exposures and (ii) the current treatment for municipal obligations.

The Agencies have requested 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

#### Recognized Financial Collateral

The Agencies' existing 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. 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 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 B above.

The Agencies have requested comment on whether this approach for expanding the scope of eligible collateral improves risk sensitivity without being overly burdensome.

#### Eligible Guarantors

Under the Agencies' existing risk-based capital framework there is only limited recognition of guarantees provided by independent third parties.

The Agencies have suggested 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, above.

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

Under the Agencies' existing rules, most one-to-four family mortgages that are first liens are generally eligible for a 50 percent risk weight. 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)**

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

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. Arrangements that require a banking organization to absorb any amount of loss before the PMI provider would not be recognized under this approach. The Agencies could place risk-weight floors on mortgages that are subject to PMI.

The Agencies have requested 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. 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**

<b>Credit Quality</b> <b>LTV Ratio</b>	<b>Low</b>	<b>Medium</b>	<b>High</b>
<b>High</b>	<b>Highest Risk</b>	→	
<b>Medium</b>	↓	↘	
<b>Low</b>		<b>Lowest Risk</b>	

**Capital Requirements Decline as Collateral Increases**

**Capital Requirements Decline as Credit Quality Improves**

The Agencies have suggested that 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 have requested 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 a borrower’s credit assessments fluctuate.

The Agencies have noted that they 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.

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 have requested 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.<sup>4</sup> The Agencies have requested comment and 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 possible 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.

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<sup>4</sup> To qualify, these loans must meet various requirements for amortization schedules, minimum maturity, LTV, and other requirements.

#### G. Short-Term Commitments

Under the Agencies' existing risk-based capital standards, short-term commitments with an original maturity of one year or less (with the exception of short-term liquidity facilities providing liquidity support to asset-backed commercial paper (ABCP) programs)<sup>5</sup> are converted to an on-balance sheet credit equivalent amount using the zero percent credit conversion factor (CCF). The Agencies are considering applying a 10 percent CCF on short-term commitments generally. 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.<sup>6</sup>

The Agencies have requested comment on this approach and 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 have requested comment on all aspects of this potential change in treatment.

#### I. Commercial Real Estate (CRE) Exposures

The Agencies are considering assigning certain acquisition, development and construction (ADC) loans to a higher than 100 percent risk weight. The Agencies are further considering exempting ADC loans from the higher risk weight if the ADC exposure meets the Interagency Real Estate Lending Standards

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<sup>5</sup> Unused portions of eligible short-term ABCP liquidity facilities are assigned a 10 percent credit conversion factor.

<sup>6</sup> For example, the CCF for unconditionally cancelable commitments related to unused portions of retail credit card lines would remain at zero percent.

regulations<sup>7</sup> 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 have asked for 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 have also requested comment on alternative ways to make risk weights for commercial real estate loans more risk sensitive.

#### 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. 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.

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 have requested comment on these and any alternative approaches for improving risk sensitivity of the risk-based capital treatment for small business loans.

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<sup>7</sup> 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).

K. Early Amortization

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 referenced in the ANPR 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 would be to assess capital against these types of securitizations based on key indicators of risk, such as excess spread levels.

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 have requested comment on whether to adopt either 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 have also requested 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.

**Scope of Application of the Proposed Revisions**

The Agencies have said that they 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 have requested 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 have requested comment on the merits of this type of approach.

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If you have any questions regarding the ANPR please call Jim Croke at +1-212-504-6139 or Peter Manbeck at +1-212-504-6626.