

**Statement of  
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Division of Risk Management Supervision  
Federal Deposit Insurance Corporation  
on  
Examining the Impact of the Proposed Rules  
To Implement Basel III Capital Standards  
before the  
Subcommittee on Financial Institutions  
and  
Consumer Credit and Subcommittee  
on  
Insurance, Housing and Community  
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Chairman Capito, Chairman Biggert, Ranking Member Maloney, Ranking Member Gutierrez and members of the Subcommittees, thank you for the opportunity to testify today on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the recently proposed changes to the federal banking agencies' regulatory capital requirements. The FDIC has had a longstanding concern for stronger bank capital requirements, and we welcome the opportunity to discuss these important proposals. The federal banking agencies have received and are carefully reviewing a significant number of comments on these proposals.

**Background**

As you know, in June of this year, the federal banking agencies issued for public comment three separate Notices of Proposed Rulemaking, or NPRs, proposing changes to the regulatory capital requirements. Two of the NPRs would implement the recent Basel III standards developed by the Basel Committee on Banking Supervision and update our regulations in conformity with Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The first of these, the Basel III NPR, would strengthen the quality of bank capital and increase its required level for all institutions, including community banks. The Basel III NPR also includes selected Basel III capital requirements applicable only to banking organizations that use the agencies' Advanced Approaches capital regulation. The second NPR, the Advanced Approaches NPR, proposes additional requirements from the Basel III agreement and other Basel standards for these large Advanced Approaches organizations. The third NPR, referred to as the

Standardized Approach NPR, proposes changes to the risk-weighting of assets and replaces credit ratings in the agencies' capital regulations in accordance with Section

939A of the Dodd-Frank Act. This NPR would apply to all institutions. The comment period on all three NPRs closed on October 22, 2012. Also, in June of this year, the agencies finalized regulations that change the way banks with a large volume of trading activity calculate capital requirements for market risk.

The agencies proposed the NPRs to address deficiencies in bank capital requirements that became evident in the recent banking crisis. A number of banking organizations failed or required federal assistance during the crisis, and the U.S. government provided capital, liquidity and guarantees to a significant portion of the financial sector, including depository institution holding companies and their affiliates. Since January 1, 2008, 463 FDIC-insured banks have failed.

In light of this experience, strengthening bank capital requirements seems to be an appropriate and important step. All banks need strong capital to navigate periods of economic turbulence while continuing to serve their important role as financial intermediaries to the economy. The changes proposed in the NPRs are intended to address identified deficiencies in the existing capital regime and provide greater comfort in the capital adequacy of our banking system. At the same time, reviewing the numerous comments received will help us address concerns about the costs and potential unintended consequences of various aspects of the proposals.

My testimony will describe the proposed rules in more detail, along with some of the most frequently identified concerns among the more than 2000 comments we have received. It is worth emphasizing that the rulemaking process is ongoing and the agencies have not yet reached final decisions regarding how to address the various issues that have been raised with respect to the NPRs.

### **The Basel III NPR**

One of the critical lessons learned from the recent financial crisis was that high-quality, loss-absorbing capital is essential to ensuring the safety and soundness of financial institutions. As such, in the aftermath of the crisis, the FDIC and the other U.S. banking agencies participated in an intensive international effort to strengthen bank capital standards. The result of these efforts is the Basel III capital agreement. In broad terms, the Basel III capital standards aim to improve the quality and increase the required level of bank capital. Collectively, Basel III and other standards published by the Basel Committee address a number of features of capital regulation that allowed for an excessive use of leverage in the years leading up to the crisis.

The FDIC Board of Directors voted to issue the Basel III NPR for public comment on June 12, 2012. The Basel III NPR proposes to strengthen the definition of regulatory capital to better absorb losses than under current rules, and to increase the required level of capital. These changes are proposed to be phased in over time. The NPR also includes selected requirements that apply only to banks using the agencies' Advanced Approaches capital regulation.

The Basel III NPR proposes a number of changes to strengthen the definition of capital. The most important of these changes are described below.

- Under current rules, common equity is permitted to comprise as little as half of Tier 1 capital, reducing the loss absorbency of, and market confidence in, the regulatory capital measure. The Basel III NPR proposes a new risk-based capital requirement for “common equity Tier 1,” a form of regulatory capital that would be more reliably available to absorb losses.
- Intangible assets, except for a limited amount of mortgage servicing rights, are deducted from capital in the Basel III NPR. Intangible assets, which are generally difficult to sell in order to absorb losses, are subject to limits in current capital rules, but the NPR makes these limits more stringent.
- Deferred tax assets are subject to stricter limits in the Basel III NPR. These assets, as analysts noted during the crisis, may have little value when a bank is losing money and capital support is most needed.
- Investments in the capital instruments of other financial institutions that exceed specified thresholds are deducted from capital in the Basel III NPR. It was evident in the recent crisis that inclusion of large amounts of such investments in a banking organization’s capital can create a chain of interconnected losses that exacerbates a banking crisis.
- Minority interests in consolidated subsidiaries are subject to stricter limits in the Basel III NPR. Minority interests can absorb losses in a specific subsidiary but may be unavailable to absorb losses throughout an organization.
- Trust Preferred Securities (TruPS) are subject to a phase-out from Bank Holding Companies’ (BHCs) Tier 1 capital in the Basel III NPR (a three year phase-out for large BHCs and a ten-year phase-out for smaller BHCs). TruPS can absorb losses in a failure, but do not absorb losses on a going-concern basis. The application of this proposed change to smaller BHCs, and the change to the treatment of accumulated other comprehensive income described below, have been frequent subjects of concern from commenters.
- Accumulated other comprehensive income (AOCI), which includes unrealized gains and losses on available-for-sale (AFS) securities, is proposed to be included in the calculation of capital under the Basel III NPR.<sup>1</sup> Incorporating these gains and losses as proposed in the NPR may result in a better indicator of the bank’s capital strength if it is forced to sell these securities in an adverse economic environment.

We are carefully considering the comments we have received on each of these proposed changes to the definition of capital.

As noted above, the Basel III NPR proposes to establish a new risk-based capital requirement for “common equity Tier 1” capital. Under the NPR, banks would need to hold common equity Tier 1 capital in an amount that is at least 4.5 percent of risk-weighted assets in order to be considered “Adequately Capitalized.” The NPR also proposes to increase by two percentage points the minimum and “Well Capitalized” levels for the Tier 1 risk-based capital ratios that are part of the agencies’ Prompt Corrective Action (PCA) regulations.

The Basel III NPR also proposes a capital buffer incorporating a sliding scale of dividend restrictions for banks whose risk-based capital ratios are less than 2.5 percentage points higher than the regulatory minimums. The purpose of the buffer is to encourage banks to maintain a cushion of capital above the regulatory minimums so they will be able to continue to lend during periods of economic adversity without breaching those minimums. The Basel III buffer is similar to the statutory requirement that the agencies’ PCA regulations include a capital ratio threshold for banks to be considered “Well Capitalized.”

In addition, the Basel III NPR requires banks that use the Advanced Approaches capital regulation to comply with a supplementary leverage ratio that includes certain off-balance sheet items in the denominator. The FDIC views the leverage ratio as a foundational measure of capital, and we are highly supportive of its inclusion in the Basel framework. The complexities specific to the Basel III leverage ratio, however, are mainly relevant for very large institutions with extensive off-balance sheet activities. For that reason, the agencies have proposed that the Basel III leverage ratio would be a supplementary requirement, and only applied to banks using the Advanced Approaches capital regulation. The existing U.S. leverage ratio requirements would remain in effect for all U.S. banks.

The Basel III NPR also requires Advanced Approach banking organizations to hold additional capital in the form of a “countercyclical buffer” if the agencies determine that the banking industry is experiencing excessive credit growth. The NPR indicated that the countercyclical buffer initially would be set at zero, with the agencies acting jointly to raise that level, if and when credit conditions warranted putting this buffer into effect. If a determination was made that the buffer was necessary, the amount of the buffer could be as much as 2.5 percent of risk weighted assets. The countercyclical buffer would serve to provide additional capital for the losses that often follow a period of excessive credit growth, and may itself serve as a check on excessive growth. Again, the NPR indicates that the countercyclical buffer would only be in effect when credit conditions warrant and would be zero at other times.

The minimum capital ratios and capital buffers proposed in the Basel III NPR were developed as part of a Basel Committee effort, in which the agencies participated, to estimate the amount of bank capital needed to absorb losses in severe economic scenarios including the losses experienced in banking crises in different countries over time. The results of this analysis were published in October, 2010.<sup>2</sup> The results

suggest that bank capital ratios at the levels agreed to by the Basel Committee and proposed in the Basel III NPR would provide reasonable assurance that banks would be able to absorb losses during a period of economic adversity while continuing to be able to lend -- and certainly greater assurance than exists under the current rules.

While working as part of the Basel Committee to develop the capital ratios that were proposed in the Basel III NPR, the agencies were mindful that while the requirements should be sufficient to enable banks to withstand a period of economic adversity, they should not be so high as to choke off prudent lending or normal economic activity. The agencies participated in international efforts to evaluate the potential effect of the higher bank capital requirements on economic activity. This work focused on two issues. One issue is the potential costs to the broader economy of an insufficiently capitalized banking system. Experience suggests that banking crises have consistently been followed by large and long-lasting reductions in economic activity. The other -- and competing issue -- is the costs that higher capital requirements might impose by increasing the cost of credit and reducing the volume of lending.

The literature reviews and other analysis conducted as part of these international efforts generally concluded that within the range of capital requirements being considered, the economic benefits of higher capital requirements from reducing the frequency and severity of banking crises would exceed the economic costs resulting from a modest increase in the cost of credit.<sup>3</sup> This analysis supports the overall conclusion that an increase in bank capital requirements from current levels is warranted. Pre-crisis increases in leverage permitted by the current capital rules did stimulate financial institution growth and earnings for a time, but the real economy ultimately suffered a significant cost when the financial cycle turned. In addition to the financial institution failures and government assistance mentioned earlier in this testimony, the U.S. economy experienced a loss of over eight and a half million payroll jobs as a result of the recession, and it suffered a 35 percent decline in home prices as well as over 10 million new foreclosures. The decline in employment and economic activity reduced revenues at all levels of government, with fiscal effects that reverberate back to the real economy.

While we view strengthening bank capital requirements as an appropriate goal to reduce the likelihood and severity of future banking crises, the agencies also are mindful that the proposals in these three NPRs represent significant change. The review of comments that is now underway is expected to shed considerable light on the potential for unintended consequences associated with specific aspects of these proposals.

### **Advanced Approaches NPR**

In addition to the Basel III NPR, the FDIC Board of Directors approved a separate NPR on June 12 that proposes a number of enhancements to the calculation of risk-weighted assets for the large, complex banks using the Advanced Approaches. This NPR proposes to implement aspects of Basel III that are designed to improve and strengthen modeling standards, the treatment of counterparty credit risk, credit risks associated

with securitization exposures, and disclosure requirements. The proposal also contains alternatives to credit ratings consistent with Section 939A of the Dodd-Frank Act. The proposals in this NPR would strengthen the existing Advanced Approaches capital rules, particularly those related to capital requirements for derivatives.

The FDIC has had a longstanding concern about the reliance in the Advanced Approaches rule on a bank's own models and risk estimates. Section 171 of the Dodd-Frank Act (the Collins Amendment) addresses this concern by placing a floor under the Advanced Approaches capital requirements that ensures that the Advanced Approaches capital requirements are not less than the requirements that are generally applicable to other banks.

### **Standardized Approach NPR**

The third NPR, the Standardized Approach proposal, includes a number of proposed changes to the calculation of risk-weighted assets in the agencies' general risk-based capital rules. The proposal also includes alternatives to credit ratings consistent with Section 939A of the Dodd-Frank Act. The capital requirements proposed in the Standardized Approach NPR are separate and distinct from those under the Basel III framework.

The Standardized Approach proposal was designed to address shortcomings in the measurement of risk-weighted assets that became apparent during the recent financial crisis. In part, this is addressed by implementing certain changes based on the Basel II Standardized Approach contained in the Basel international regulatory capital standards and by replacing credit ratings consistent with section 939A of the Dodd-Frank Act. The proposed risk-weightings and segmentation methodologies for residential mortgages were developed by the federal banking agencies in response to issues observed during the financial crisis. Among other things, the proposed rule would:

- revise risk weights for residential mortgages based on loan-to-value ratios and certain product and underwriting features;
- increase capital requirements for past-due loans, high volatility commercial real estate exposures, and certain short-term loan commitments;
- expand the recognition of collateral and guarantors in determining risk-weighted assets;
- remove references to credit ratings; and
- establish due-diligence requirements for securitization exposures.

FDIC-insured institutions have strengthened their capital ratios since 2008. We have estimated that the large majority of insured banks would meet the capital requirements resulting from the combined implementation of the Basel III NPR and the Standardized Approach NPR. The attachment to this testimony describes the methodology for these

estimates and the results for banks in different size groups. These estimates suggest that for most insured banks, the proposals would not result in a need to raise new capital. It should be emphasized that these are estimates, and that institutions themselves will have better information about the specific factors used in the proposed capital calculations than the agencies currently collect in financial reports. In particular, our estimates did not attempt to address the extent to which institutions might feel the need to hold additional capital buffers beyond those specifically proposed, for example, to offset future changes in AOCI. Our review of the public comments is expected to shed additional light on such issues.

### **Final Market Risk Rule**

On June 12, the FDIC Board of Directors also approved the final regulation making improvements to the Market Risk Rule. This final regulation, which takes effect on January 1, 2013, addresses important weaknesses of the current Market Risk Rule to reflect lessons learned in the financial crisis. Leading up to the crisis, low capital requirements under the current Market Risk Rule encouraged institutions to place illiquid, high-risk assets in their trading books. Large mark-to-market losses on these assets played an important role in fueling the financial crisis during its early stages. The final regulation requires an appropriate increase in the stringency of the Market Risk Rule that will better address such risks.

This final rule applies only to the largest institutions that have significant trading activities. It is based on reforms that were agreed to internationally with the Basel Committee's 2009 revisions to the Basel II market risk framework. These revisions are part of what is generally referred to as the Basel II.5 reforms.

Concerns have been expressed that the Market Risk Rule, while improved, is still too reliant on internal models. The idea of establishing a simple, non-modeled and higher minimum capital floor for all trading book capital requirements is worthy of further study, and is in fact being considered as part of a fundamental review of trading book capital requirements being conducted by the Basel Committee.

### **Outreach and Comments**

As the primary federal supervisor for the majority of community banks, the FDIC is particularly focused on ensuring that community banks are able to properly analyze the capital proposals and assess their impact. Since the Basel III NPR and the Standardized Approach NPR would affect all banks, the FDIC undertook an outreach agenda to assist community banks in analyzing the impact of the proposals.

First, both the Basel III NPR and the Standardized Approach NPR contain a relatively short and concise addendum designed to aid smaller banks in identifying and understanding the aspects of the proposal that would apply to them.

Second, FDIC staff hosted six community bank capital outreach sessions, one in each of the FDIC regional offices. Each session included an FDIC staff overview of the NPRs

that identified the most significant changes for community banking organizations, and a question-and-answer session for the bankers in attendance.

Third, the FDIC posted an on-demand video on its Website that contains the same information provided by the FDIC in the live outreach sessions. Copies of the materials provided to bankers at the live outreach sessions are also posted online.

Fourth, FDIC staff hosted a national call to address the questions most frequently asked by attendees at the live outreach program sessions.

Finally, the FDIC, along with the other banking agencies, developed a Regulatory Capital Estimation Tool designed to assist community banking organizations and other interested parties in evaluating the potential effect that the Basel III NPR and the Standardized Approach NPR could have on their capital ratios.

We believe that these outreach efforts have helped many bankers understand these proposals and identify the issues that are of concern to them. As of November 16, the FDIC had received more than 2000 comments. The vast majority of these comments are from community banks. Their comments have been highly substantive and provide significant information regarding the possible impact of the proposals.

The FDIC is in the process of reviewing all of the comments received. To date, many commenters have raised concerns about the generally higher level of capital requirements for community banks. A number of commenters have requested that the agencies not apply the Basel III or Standardized Approach NPRs to community banks. Some commenters have requested that the agencies withdraw the Standardized Approach NPR.

In addition to these general comments, a few more specific topics have been mentioned quite frequently. First, many commenters have expressed concern that the Basel III NPR proposes to include AOCI in the calculation of regulatory capital, thereby including gains and losses on available-for-sale debt securities. These commenters believe that the inclusion of AOCI will increase the volatility of regulatory capital, forcing banks to hold additional capital buffers, and complicate their ability to manage interest rate risk and comply with legal lending limits. Also with respect to the Basel III NPR, many commenters have expressed concern that trust preferred securities issued before May 19, 2010, by community bank holding companies with less than \$15 billion in assets are proposed to be phased out of Tier 1 capital.

With respect to the Standardized Approach NPR, many commenters have expressed concern about the increased complexity and systems costs of the proposed new methods for asset risk weighting, as well as the proposed increase in risk weight for certain exposures, particularly past due exposures and residential mortgages. Many community bank commenters have indicated that the proposed risk-weightings for residential mortgages will force them to curtail or exit residential mortgage lending because of what they view as the excessively high level of some of these risk weights.

Commenters also express concern about how the new risk weights might interact with a number of pending mortgage regulations whose final form remains uncertain.

## **Conclusion**

In conclusion, along with our fellow regulators, the FDIC is carefully reviewing the comments we have received regarding the NPRs. These are proposed rules, and we expect to make changes based on the comments. The basic purpose of the Basel III framework is to strengthen the long-term quality and quantity of the capital base of the U.S. banking system. In light of the recent financial crisis, that would appear to be an appropriate and important goal. However, that goal should be achieved in a way that is responsive to the concerns expressed by community banks about the potential for unintended consequences.

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<sup>1</sup> Under existing regulations, unrealized gains and losses on AFS debt securities are not included in regulatory Tier 1 capital. Unrealized losses on AFS equity securities with readily determinable fair value are included in Tier 1 capital, while a portion of unrealized gains on AFS equity securities can be included in Tier 2 capital.

<sup>2</sup>“Calibrating Regulatory Minimum Capital Requirements and Capital Buffers: A Top-down Approach,” October, 2010, Basel Committee on Bank Supervision; <http://www.bis.org/publ/bcbs180.htm>.

<sup>3</sup> “An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements,” August, 2010; Basel Committee on Bank Supervision; <http://www.bis.org/publ/bcbs173.htm>, and “Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements (MAG Analysis),” December, 2010, Financial Stability Board and Basel Committee on Bank Supervision; <http://www.bis.org/publ/othp12.pdf>.

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