



FDIC Modifies Regulatory Capital Rules

Information is based on an analysis of recent press releases issued by U.S. federal banking regulatory agencies and industry representatives and is intended to provide guidance to financial institutions.

January 13, 2010 – Working with other federal bank regulatory agencies, in mid-December 2009, the Federal Deposit Insurance Corporation (FDIC) finalized regulatory capital rules that set the time line for the implementation of higher minimum capital requirements triggered by two new Financial Accounting Standards Board (FASB) accounting standards, FAS 166 and 167.

Financial Accounting Standards No. 166, *Accounting for Transfer of Financial Assets - an Amendment of FASB Statement No. 140* (FAS 166), and Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46R* (FAS 167) will change how banks account for securitized assets not on their balance sheets.

To delay the affect on risk-based capital and the allowance for lease and loan losses (ALLL) the FDIC is allowing an optional maximum phase-in of one year.

KEY POINTS

The adoption of FAS 166 and FAS 167 moves most securitizations from variable interest entities (VIE) back onto issuers' balance sheets by January 1, 2010. The assets include residential and commercial mortgage-backed securities. The FDIC is allowing a temporary reprieve by delaying the adoption of FAS 166 and FAS 167 for one year. The FDIC's final rule addresses the following key points:

- 1) *Transition period for financial institutions to adopt FAS 166 and FAS 167.* The regulatory agencies allowed an optional two-quarter delay to adopt FAS 166 and FAS 167. The two-quarter delay does not require modification of current regulatory reporting. Following the delay, the FDIC allowed a two quarter phase-in to report the recognition effect of risk-weighted assets and ALLL. If a financial institution chooses to use the phase-in period, it will apply to all applicable VIEs.
- 2) *FAS 166 and FAS 167 regulatory capital requirements.* The FDIC did not deem it appropriate to warrant permanent modification of risk-based capital rules as requested by financial institutions. Instead, regulatory agencies decided to allow the optional transition period for adoption of FAS 166 and FAS 167. This decision was based partially on revelations from the recent financial crisis — regulatory agencies' beliefs that financial institutions' credit risk exposure was greater than they had estimated. Tier 1 leverage ratio will be affected by the new capital requirements.
- 3) *Asset-backed commercial paper programs (ABCP).* The ABCP exclusion permits a financial institution to exclude risk-weighted assets from an ABCP program for which it acts as sponsor. The current regulatory requirement allows only the contractual obligation of the assets to be included in the calculation of risk-weighted assets. Financial institutions opposed elimination of the ABCP exclusion. The FDIC felt there was not a workable alternative and has chosen to eliminate the ABCP exclusion.

- 4) *Reservation of authority.* The FDIC decided that a financial institution's primary federal supervisor has the authority to require that an off-balance sheet VIE be consolidated onto the financial institution's balance sheet.

SCOPE

The FDIC's new capital modification ruling will affect all financial institutions, including banks, thrifts and investment banks that own applicable VIEs. By the third quarter of 2010, regulatory reporting modifications will have to be made by financial institutions that choose the optional delay and phase-in period.

IMPACT TO BUSINESSES

The major impact to financial institutions with VIEs will be the required increase in capital due to their risk-weighted asset calculation. It's estimated as much as \$443 billion in assets will be moved from VIEs back to the balance sheets of the world's four largest banks. If necessary, the FDIC will give financial institutions until mid-2011 to rebuild capital and repair balance sheets. According to the report accompanying the FDIC's December 16, 2009, press release, financial institutions argued that requiring an increase in capital would "have a negative and procyclical impact on financial markets and the economy, particularly as banking organizations recover from the recent financial crisis and recession, by increasing the cost of and ultimately curtailing lending." There is also a concern the ruling will put U.S. financial institutions at a disadvantage to their foreign competitors.

Leverage ratios will also be affected negatively by this ruling. It's expected that financial institutions will see an increase of the denominator, causing a decrease in the leverage ratio. Regulatory agencies concluded a delay or phase-in was not appropriate based on the leverage ratio's purpose and history, so the effect on a financial institution's leverage ratio will be immediate.

While additional time may be beneficial, a financial institution that chooses to take advantage of the transition period will need to have two sets of financial records; one set for financial reporting under GAAP and one set for regulatory reporting to record contractual exposure of VIEs, a potentially burdensome and costly prospect.

HOW JEFFERSON WELLS CAN HELP

Financial institutions face a fundamental shift in the regulatory approach to capital adequacy. Jefferson Wells assists financial institutions in risk assessment, regulatory compliance and capital adequacy reviews, loan review, credit quality assessments and internal audit services.

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