News Bulletin

January 25, 2010

Banking Agencies Issue Final Regulatory Capital Rule Related to FAS 166 and 167

On January 21, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision and the Federal Deposit Insurance Corporation (the "Banking Agencies") issued the final risk-based capital rule (the "Rule") related to the Financial Accounting Standards Board's adoption of Statement of Financial Accounting Standard 166, Accounting for Transfers 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. 46(R) ("FAS 167"). FAS 166 and FAS 167 make substantive changes to how banking organizations account for many items, including securitized assets, that had been previously excluded from their balance sheets. Most banking organizations are required to implement the new consolidation standards of FAS 166 and FAS 167 as of January 1, 2010. Banking organizations affected by FAS 166 and FAS 167 generally will be subject to higher risk-based regulatory capital requirements intended to better align risk-based capital requirements with the actual risks of certain exposures.

FAS 166 and FAS 167, among other things, establish new standards for reporting companies' transfers of assets to certain special purpose entities, known as variable interest entities ("VIEs") under U.S. generally accepted accounting principles ("GAAP"), and for consolidating VIEs. As a result, banking organizations may be required to consolidate assets, liabilities, and equity in certain VIEs that were not consolidated under the standards that FAS 166 and FAS 167 replaced. The Banking Agencies' risk-based capital and leverage rules (collectively, the "capital rules") generally would require a banking organization to include assets held by newly consolidated VIEs in its leverage and risk-based capital ratios determined under those rules and require a consolidating banking organization to establish an allowance for loan and lease losses ("ALLL") to cover estimated credit losses on assets consolidated under FAS 167. Therefore, the implementation of FAS 166 and 167 likely will cause both the leverage and risk-based capital ratios of banking organizations that now must consolidate VIEs to fall by varying amounts.

In formulating the Rule, the Banking Agencies endeavored to balance the short-term need to maintain stability in the capital markets with the long-term goal of maintaining financial stability. The Rule is intended to provide breathing room to banking organizations by utilizing a delay and phase-in period without compromising the philosophy that regulatory capital requirements should reflect banking organizations' exposure to credit risk. The Rule amends the Banking Agencies' general risk-based and advanced risk-based capital adequacy frameworks by:

(1) eliminating the exclusion of certain consolidated asset-backed commercial paper ("ABCP") programs from risk-weighted assets;

(2) providing for an optional two-quarter implementation delay followed by an optional two-quarter partial implementation of the effect on risk-weighted assets that will result from changes to GAAP due to the adoption of FAS 166 and FAS 167;

Attorney Advertisement

(3) providing for an optional two-quarter delay, followed by an optional two-quarter phase-in, of the application of the Banking Agencies' regulatory limit on the inclusion of the ALLL in tier 2 capital for the portion of the ALLL associated with the assets a banking organization consolidates as a result of FAS 167; and

(4) providing a reservation of authority to permit the Banking Agencies to require a banking organization to treat entities that are not consolidated under GAAP as if they were consolidated for risk-based capital purposes, commensurate with the risk relationship of the banking organization to the structure.[1]

Relying on empirical analysis and supervisory information, the Banking Agencies concluded that any short-term effects of eliminating the ABCP exclusion, which previously permitted a banking organization to exclude from risk-weighted assets the assets of an ABCP program that it is required to consolidate under GAAP and for which it acts as a sponsor, would be outweighed by the fact that elimination of the exclusion would, in the Banking Agencies' view, better reflect the banking organization's risk exposure. Citing lessons learned from the financial crisis, the Banking Agencies noted that the exclusion only took into account the banking organization's contractual risk exposure rather than the actual risk exposure, such as the implicit support sponsors have historically provided to mitigate reputational risk and participation in regulatory capital arbitrage.

Further, although the Banking Agencies determined that the largest banking organizations, those most likely to be affected by the passage of FAS 166 and 167, will not be inadequately capitalized if the regulatory capital requirements are not permanently modified, the Banking Agencies recognized the fragile state of the securitization market, the expected upcoming termination of government-supported programs, and the lack of credit available in the market, and concluded that a delay and phase-in period will enable a stable and orderly transition to consolidation of VIEs for risk-based capital purposes. During the delay, or exclusion, period a banking organization may choose to exclude from risk-weighted assets those assets held by VIEs, provided that (1) the VIE existed prior to the implementation date, and (ii) the banking organization did not consolidate the VIE on its balance sheet for calendar quarter-end regulatory report dates prior to the implementation period. During the subsequent two-quarter phase-in period, the excluded assets would be gradually included in risk-weighted assets. The optional transition period and associated rules also apply to ABCP program VIEs.

If a banking organization continues to apply the exclusion to any VIE or any ABCP program VIE pursuant to the optional transition rules, it must apply the exclusion to all VIEs or ABCP program VIEs, as applicable. Furthermore, the transition mechanism is not applicable for any assets of a VIE to which the banking organization has provided recourse through credit enhancement beyond contractual obligations. For any assets of consolidated VIEs that the banking organization chooses to continue to exclude from risk-weighted capital during the transition period, the banking organization may also include in tier 2 capital during the initial two-quarter delay period the full amount of the ALLL calculated as of the implementation date that is attributable to the excluded assets, and up to 50% of that amount during the subsequent two-quarter phase-in period, subject to certain adjustments.

The Rule will take effect 60 days after publication in the *Federal Register*, which is expected shortly. The delay and subsequent phase-in periods of the implementation of the Rule will apply only to the Banking Agencies' risk-based capital requirements, not the leverage ratio requirement. Banking organizations may choose to comply with the Rule as of the beginning of their first annual reporting period after November 15, 2009.

[1] Available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20100121a1.pdf (last viewed on January 21, 2009).

Attorney Advertisement

MORRISON | FOERSTER

Contacts

Melissa D. Beck
(212) 336-4319
mbeck@mofo.com

Kenneth E. Kohler
(213) 892-5815
kkohler@mofo.com

Anna T. Pinedo
(212) 468-8179
apinedo@mofo.com

About Morrison & Foerster

With more than 1000 lawyers in 16 offices around the world, Morrison & Foerster offers clients comprehensive, global legal services in business and litigation. The firm is distinguished by its unsurpassed expertise in finance, life sciences, and technology, its legendary litigation skills, and an unrivaled reach across the Pacific Rim, particularly in Japan and China. For more information, visit www.mofo.com.

© 2010 Morrison & Foerster LLP. All rights reserved.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.