

## Federal Banking Agencies Implement Collins Amendment by Establishing Risk-Based Capital Floor

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Pursuant to the Collins Amendment of the Dodd-Frank Act, the Federal Reserve Board, FDIC and OCC have adopted a [final rule](#) to replace the transitional floors in the Federal banking agencies' Basel II internal-ratings based and advanced measurement approaches for risk-based capital (the "**advanced approaches**") with a permanent capital floor equal to the risk-based capital requirements under the banking agencies' Basel I capital adequacy guidelines (the "**general rules**"). As a result, a U.S. depository institution or bank holding company (each, a "**banking organization**") operating under the advanced approaches must calculate its risk-based capital ratios under both the general rules and the advanced approaches. The banking organization must then use the lower of the two Tier 1 risk-based capital ratios and the lower of the two Total risk-based capital ratios to determine whether it meets its minimum risk-based capital requirements. The final rule is unchanged from the rule proposed by the agencies in December 2010.

### Collins Amendment

Under the Collins Amendment, the Federal banking agencies are required to establish minimum leverage and risk-based capital requirements to apply to insured depository institutions, bank and thrift holding companies and systemically important nonbank financial companies. These minimum requirements must be not less than the generally applicable risk-based capital and leverage capital requirements, and not quantitatively lower than the above requirements that were in effect for insured depository institutions as of the date of enactment of the Dodd-Frank Act (July 21, 2010). The Collins Amendment is discussed in greater detail in an earlier [Davis Polk memorandum](#), which is attached to this memorandum.

### Amending the Advanced Approaches

In 2007, the Federal banking agencies adopted the advanced approaches, which are mandatory for U.S. banking organizations that meet certain consolidated total assets or foreign exposure thresholds. The advanced approaches established a series of transitional floors designed to restrict the amount by which a banking organization's risk-based capital requirements could decline relative to the general rules after the completion of a satisfactory parallel run. Still, banking organizations using the advanced approaches could theoretically operate with lower minimum risk-based capital requirements during a transitional floor period, and potentially thereafter, than would be required under the general rules. In other words, the general risk-based capital requirements did not serve as a floor for the advanced approaches.

Under the final rule implementing the capital floor requirement of the Collins Amendment, the banking agencies have now introduced a permanent floor. The amendments to the banking agencies' respective advanced approaches express the floor as the Tier 1 risk-based capital ratio or Total risk-based capital ratio, as applicable, calculated in accordance with the general rules applicable to banks.

Currently the general rules are based on the Basel I capital accord, and there is nothing in the text of the amendments to the advanced approaches to specifically indicate that the floor consists of the general rules as in effect from time to time. However, in the text of the release, the agencies clarified that the general rules "will evolve over time" and that the floor is not intended to be a "permanent Basel I based floor."

The agencies also confirmed that they expect to perform a quantitative analysis of any new capital requirements in the future to satisfy the statutory mandate that any such requirements not be “quantitatively lower” than the general rules in effect on the date of enactment of the Dodd-Frank Act. As a result, they do not expect to require banking organizations to compute two sets of floor calculations: one against the general rules then in effect and another against the general rules in effect on July 21, 2010.

Lastly, the final rule permits a banking organization or a nonbank financial company supervised by the Federal Reserve Board to assign an asset not specifically included in one of the general rules’ risk weight categories to a lower risk weight category than 100%, provided that:

- the banking organization is not authorized to hold the asset (except under the debt previously contracted or similar authority); and
- the risks are substantially similar to those of assets that are otherwise assigned to a risk weight category less than 100%.

Consistent with the Collins Amendment, the final rule provides that a bank holding company operating under the advanced approaches may include certain debt or equity instruments issued before May 19, 2010 when calculating its risk-based capital ratios. The Collins Amendment’s regulatory capital deductions for debt or equity instruments are further discussed in the above-mentioned [Davis Polk memorandum](#).

## Practical Effect of the Final Rule

The immediate effect of the final rule is to deny any positive effect of calculating a banking organization’s risk-based capital under the advanced approaches compared to the general rules. If the current Basel I general rules remain unchanged but for the higher minimum risk-based capital ratios prescribed by Basel III, it is unclear what incentive a banking organization that is not mandatorily subject to the advanced approaches would have to make the investments required to adopt the advanced approaches. In the parallel run period and going forward, if the Basel II capital requirements for banking organizations using the advanced approaches were consistently lower than their capital requirements calculated under the Basel I general rules, this might provide empirical validation for the concept of a capital floor from a safety and soundness perspective. On the other hand, if the parallel run and future experience of the banking organizations using the advanced approaches were that their Basel II capital requirements are consistently higher than their capital requirements calculated under the Basel I general rules, that might suggest that the general rules would function as a cap rather than a floor for the banking organizations not subject to the advanced approaches. In that case it is unclear what the justification would be, from a safety and soundness perspective, not to require a broader adoption of the advanced approaches in the United States.

The longer-term effect of the final rule will depend on whether and to what extent the federal banking agencies may modernize the general rules to reflect potentially more sophisticated assessments of credit, market and other risks than those under the current Basel I general rules. This in turn would depend on whether the agencies would be able to adopt new general rules that, in the aggregate, would impose quantitatively equal or higher capital requirements, but which may allow a banking organization on an individual basis to benefit from a lower amount of required capital because, for example, its credit and other exposures present a lower risk profile.

On these factors will also turn the potential competitive impact of the final rule on U.S. banking organizations relative to the risk-based capital requirements applicable to non-U.S. banking organizations in jurisdictions outside the United States.

## Capital Equivalency for Non-U.S. Banking Organizations

As for non-U.S. banking organizations that wish to establish new branches or agencies in the United States, make bank or non-bank acquisitions, or elect to become a financial holding company, the final rule leaves unresolved how a federal banking agency is supposed to determine whether the capital of the foreign banking organization is equivalent to the capital that would be required of a U.S. banking organization. The Federal Reserve Board and the other banking agencies have generally been requiring foreign banking organizations subject to Basel II capital standards to provide their Basel I calculations for purposes of complying with their jurisdictions' transitional floors. But now that many foreign banking organizations are no longer subject to such transitional floors, they no longer perform any Basel I-based calculations. In the final rule's release, the federal banking agencies noted the "challenges" of resolving these issues for purposes of establishing a consistent process for evaluating capital equivalency, but offered no current solution except to state that they "will continue to evaluate equivalency issues on a case-by-case basis taking into consideration the comments received."

## Effective Date of Final Rule

The final rule will be effective 30 days after publication in the Federal Register, which is expected to occur soon.

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## Collins Amendment – Minimum Capital and Risk-Based Capital Requirements

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The Collins Amendment, originally drafted by the FDIC staff and reflecting [views held by Chairwoman Bair](#), imposes, over time, the leverage and risk-based standards currently applicable to U.S. insured depository institutions on U.S. bank holding companies, including U.S. intermediate holding companies of foreign banking organizations, thrift holding companies and systemically important nonbank financial companies. One of the effects of the Collins Amendment is to eliminate trust preferred securities as an element of Tier 1 capital. Implementing regulations must be issued no later than 18 months from the bill's effective date. As with all changes in capital requirements, there are highly negotiated transition periods and grandfathering exemptions, which we describe below. Please see a more complete implementation timeline at the end of this memorandum.

The Collins Amendment also directs the appropriate federal banking supervisors, subject to Council recommendations, to develop capital requirements for all insured depository institutions, depository institution holding companies and systemically important nonbank financial companies to address systemically risky activities.

The Collins Amendment echoes changes that have been proposed but not yet been adopted by the Basel Committee on Banking Supervision in the so-called "Basel III" process and those that are contemplated in the new U.S. systemic risk regulatory regime.

The U.S. banking supervisors will have the unenviable task of implementing the intersection of Collins Amendment, Basel III, capital standards under the systemic risk regime, the requirement elsewhere in the bill to adopt countercyclical regulatory capital requirements and the capital requirements that will apply to the separately capitalized subsidiaries required for certain derivatives activities. However, at a minimum, the Collins Amendment will set a floor for the U.S. banking supervisors in the ongoing Basel III discussions.

### ■ **Minimum Leverage Capital and Risk-Based Capital Requirements**

- Under the Collins Amendment, the appropriate Federal banking agencies are required to establish minimum leverage and risk-based capital requirements to apply to insured depository institutions, bank and thrift holding companies and systemically important nonbank financial companies.
- **Two Floors.** The minimum leverage capital and risk-based capital requirements applicable to these institutions are subject to two floors. They must be:
  - Not less than the generally applicable risk-based capital requirements and the generally applicable leverage capital requirements.
  - Not quantitatively lower than the above requirements that were in effect for insured depository institutions as of the date of enactment of the bill.
- **Generally Applicable Capital and Leverage Requirements.** The Collins Amendment defines "generally applicable risk-based capital requirements" and "generally applicable leverage capital requirements" to mean the risk-based capital requirements and minimum ratios of Tier1 capital to average total assets, respectively, established by the appropriate Federal banking agencies to apply to insured depository institutions under the prompt corrective action provisions of the Federal Deposit Insurance Act, regardless of total consolidated asset size or foreign financial exposure.

- The formula for “generally applicable risk-based capital requirements” must include the required ratio of regulatory capital components (numerator) over risk-weighted assets (denominator).
- The formula for “generally applicable leverage capital requirements” must include the required ratio of regulatory capital components (numerator) over average total assets (denominator).
- **Financial Subsidiary Deductions.** The Collins Amendment clarifies that the requirement applicable to national banks to deduct investments in subsidiaries that are engaged in financial activities does not apply at the holding company level or to systemically important nonbank financial companies, except, in the latter case, if so required by the Federal Reserve or primary financial regulator.
- **Basel III.** The Collins Amendment does not expressly permit the U.S. banking supervisors to amend capital adequacy guidelines in accordance with the standards that will be applied internationally when the Basel III process, which currently contemplates the publication of final standards by the end of 2010 and their effectiveness by the end of 2012, is completed. As a result, the Collins Amendment will create a statutory floor and U.S. banking regulators would be able to implement Basel III only to the extent it is consistent with the Collins Amendment floor. We believe this generally means that they would be able to impose more stringent Basel III capital rules on insured depository institutions and bank holding companies than those that have applied historically to banks but would not be able to apply less stringent rules, with the possible exception of giving effect to any countercyclical requirements contemplated by Basel III and the bill. Revised Basel III draft proposals are expected to be released this week.
- **Effects of the Application of the Collins Amendment**
  - The current leverage and risk-based capital requirements applicable to insured depository institutions – not those currently applicable to bank holding companies – will set the new minimum standard for leverage and risk-based capital requirements for insured depository institutions, depository institution holding companies and systemically important nonbank financial companies. Consequently:
    - After the transition periods described below, hybrid securities may be included only in Tier 2 capital, whereas the Federal Reserve currently allows bank holding companies to include some hybrid securities, subject to quantitative limits and other restrictions, in Tier 1 capital.

- The current leverage and risk-based capital requirements for banks are as follows:

		To be considered “well capitalized”	To be considered “adequately capitalized”
Minimum risk-based capital ratios	Tier 1 capital ratio	6%	4%
	Total capital ratio	10%	8%
Minimum leverage ratio*		5%	4%

\* A 3% minimum leverage ratio applies for institutions if the FDIC determines that the institution is not anticipating or experiencing significant growth, has well-diversified risk, among other factors, and is rated composite “1” under the CAMELS rating system.

- **Transition Periods and Permanent Exemptions**

- **General Rule.** For bank holding companies and systemically important nonbank financial companies, any “regulatory capital deductions” for debt or equity issued before May 19, 2010 will be phased in from January 1, 2013 to January 1, 2016. Exceptions are set forth below.
  - The term “regulatory capital deductions” presumably refers to the exclusion of hybrid capital, such as trust preferred securities, from Tier 1 capital.
  - The Basel Committee has proposed that countries aim to implement Basel III by the end of 2012, which coincides with the beginning of the phase-in period. As currently drafted, the Basel III rules would also exclude the forms of hybrid capital typically issued in the U.S. from Tier 1 capital, although some Basel III grandfathering and/or phase-in provisions are expected.
- **TARP Preferred.** Debt or equity instruments issued to the Federal government or any agency before the end of the Treasury’s authority to invest via TARP on October 4, 2010, are exempt from the Collins Amendment.
  - Explicitly and permanently grandfathers all TARP preferred issuances, regardless of the size of the institution.
- **Thrift Holding Companies.** For thrift holding companies, other than those in mutual form on May 19, 2010, any “regulatory capital deductions” required by the Collins Amendment for debt or equity issued before May 19, 2010 will be phased in from January 1, 2013 to January 1, 2016. Exceptions are noted below. All other requirements under the Collins Amendment, the minimum leverage and risk-based capital ratios, are effective 5 years after enactment.
- **Intermediate U.S. Holding Companies of Foreign Banks.** For domestic bank holding company subsidiaries of foreign banking organizations that have relied on the exemption from the Federal Reserve’s capital adequacy guidelines under [Supervision and Regulation Letter SR-01-1](#), the U.S. risk-based capital and leverage capital requirements and the other requirements of the Collins Amendment for debt or equity issued before May 19, 2010 will take effect 5 years after enactment.
- **Bank and Thrift Holding Companies With Less than \$15 Billion in Assets.** Does not require any “capital deductions” for debt or equity instruments issued before May 19, 2010 by a depository institution holding company with total consolidated assets of less than \$15 billion as of December 31, 2009.

- Would permanently grandfather hybrid capital for the purposes of application of the Collins Amendment to these institutions.
- **Mutual Holding Companies.** Does not require any “capital deductions” for debt or equity instruments issued before May 19, 2010 by an organization that was a mutual holding company on May 19, 2010.
- **Newly Issued.** For all institutions, the Collins Amendment is retroactively effective with respect to debt or equity issued on or after May 19, 2010 except, as noted above, TARP preferred issued by the Treasury.
- **Application to Other Financial Institutions**
  - **Nonbank Financial Companies**
    - While systemically important nonbank financial companies are subject to the Collins Amendment, in another part of the bill, the Federal Reserve has the authority to exempt systemically important nonbank financial companies from application of the risk-based capital requirements and leverage requirements. In order to do so, the Federal Reserve must determine, in consultation with the Council, that the requirements are not appropriate for a company because of the company’s activities or structure, and must apply other standards that result in similarly stringent controls.
      - If the Federal Reserve makes this determination, we do not believe that the Collins Amendment would apply to a systemically important nonbank financial company, but the interaction of the two portions of the bill is not as clear as one would hope. Assuming the better reading applies, then hedge funds, asset managers and systemically important insurance companies would have tailored, rather than bank-centric, capital standards apply to them as the new regime is implemented.
      - The Federal Reserve does not have the authority to exempt thrift holding companies that are not systemically important from the Collins Amendment. As a result, insurance companies and their holding companies that control thrifts but are not systemically important will be subject to the Collins Amendment requirements.
  - **Foreign Parents.** The requirements of the Collins Amendment would not apply to foreign parents of bank and thrift holding companies, but would apply to any U.S. bank or thrift holding company, including any intermediate holding company, that is owned or controlled by a foreign organization.
    - While not expressly stated, systemically important foreign nonbank financial companies presumably will not be subject to the Collins Amendment at the foreign parent level.
  - **Other Depository Institution Holding Companies.** Depository institution holding companies that are not bank or thrift holding companies, such as holding companies of industrial banks, credit card banks, or trust banks, are not subject to the Collins Amendment.
  - **FHLBs.** Federal home loan banks are exempt.
  - **Small BHCs.** Does not change the treatment of small bank holding companies with less than \$500 million in assets under the Federal Reserve’s [Small Bank Holding Company Policy Statement](#).
  - The following table summarizes the applicability of the Collins Amendment’s risk-based and leverage capital requirements, as well as of the exclusion for certain hybrid instruments from Tier 1 capital:

	General risk-based capital and leverage capital requirements	Exclusion from Tier 1 capital for hybrid debt or equity instruments issued before May 19, 2010*
<b>Bank holding companies</b>		
<ul style="list-style-type: none"> <li>Large bank holding companies – more than \$15 billion in assets as of December 31, 2009</li> </ul>	Effective upon implementing regulation required within 18 months	Phase-in of exclusion from January 1, 2013 to January 1, 2016
<ul style="list-style-type: none"> <li>Medium-size bank holding companies – less than \$15 billion in assets as of December 31, 2009</li> </ul>	Effective upon implementing regulation required within 18 months	Permanent grandfather
<ul style="list-style-type: none"> <li>Small bank holding companies – less than \$ 500 million in assets</li> </ul>	Exempt	Exempt
<b>Thrift holding companies</b>		
<ul style="list-style-type: none"> <li>Large thrift holding companies – more than \$15 billion in assets as of December 31, 2009</li> </ul>	Effective 5 years after enactment	Phase-in of exclusion from January 1, 2013 to January 1, 2016
<ul style="list-style-type: none"> <li>Medium to small thrift holding companies – less than \$15 billion in assets as of December 31, 2009</li> </ul>	Effective 5 years after enactment	Permanent grandfather
<b>Mutual holding companies</b>	If thrift holding companies, effective 5 years after enactment. Otherwise, effective upon implementing regulation required within 18 months	Permanent grandfather
<b>Holding companies of industrial banks, credit card banks and trust banks</b>	Not subject	Not subject
<b>Systemically important nonbank financial companies</b>	Federal reserve may exempt. Effective upon implementing regulation required within 18 months	Phase-in of exclusion from January 1, 2013 to January 1, 2016
<b>Foreign parents</b>	Not subject	Not subject
<b>Intermediate U.S. holding companies of foreign banks</b> relying on SR 01-1	Effective 5 years after enactment	Effective 5 years after enactment
<b>Federal home loan banks</b>	Exempt	Exempt

\* All institutions, except those identified above as “exempt” or “not subject,” must exclude hybrid securities issued on or after May 19, 2010 from Tier 1 capital. TARP preferred issuances issued until the end of the Treasury’s authority to invest via TARP are also exempt from this requirement.



- **Effects on the Capital Markets for Financial Institutions**

  - All bank and thrift holding companies will have to engage in careful capital planning, in light of maturities of outstanding hybrid capital.

    - Expiring hybrid capital must be replaced with other forms of Tier 1 capital, such as common equity or tangible equity units, e.g., tMeds.
    - Stronger bank holding companies may seek to replace trust preferred securities by exercising rights pursuant to regulatory capital event provisions that permit issuers to call securities early. These provisions may be triggered upon the bill's enactment or upon the start of the phase-in, depending on the terms of the instrument. If the issuer chose to call the instrument, the Federal Reserve would have to approve the call and would likely require that the trust preferred security be replaced with another form of Tier 1 capital.
  - On a sector-wide basis, we expect that this process will happen slowly because many regional and super-regional banks with assets over \$15 billion remain in a sensitive capital state. In addition, all bank and thrift holding companies will attempt to avoid diluting shareholders too quickly, but will have to balance these considerations against the risk of a crowded capital raising marketplace later during the phase-in period.
- **Capital Requirements Must Address Systemic Risks.**

  - The appropriate federal banking agencies must, subject to Council recommendations, impose capital requirements on insured depository institutions, depository institution holding companies and systemically important nonbank financial companies to address the risks arising out of certain activities to "other public and private stakeholders." At a minimum, the requirements must address risks that relate to:

    - significant volumes of activity in derivatives, securitized products, financial guarantees, securities borrowing and lending, and repos;
    - concentrations in assets for which reported values are model-based; and
    - concentration in market share for any activity that would substantially disrupt financial markets if unexpectedly discontinued by the institution.
  - The Council has authority to recommend heightened prudential standards to apply to certain activities and practices whether or not the institution in which they take place is systemically important. We expect that banking supervisors will coordinate these recommendations with the capital charges for systemically risky activities required by the Collins Amendment.
  - Basel III's capital and leverage requirements aim to address similar risks. It remains to be seen whether the capital requirements set by banking supervisors under the Collins Amendment will be commensurate with those recommended by the Basel Committee.
  - **Volcker Rule.** Systemically important nonbank financial companies will also be subject to heightened capital requirements and quantitative limits under the Volcker Rule with respect to their proprietary trading and private equity and hedge fund activities.
  - **Countercyclical Capital Requirements.** For bank and thrift holding companies as well as insured depository institutions, the bill also requires that the appropriate federal agency seek to make capital regulations countercyclical. Since this specifically contemplates that the amount of capital held by an affected institution will increase in times of economic expansion and decrease in times of economic contraction, it will be interesting to see how the banking supervisors reconcile this mandate with the Collins Amendment's "floor" mandate.

- **GAO Studies and Reports.** The GAO, in consultation with the federal banking agencies, is required to conduct three studies and submit the reports to Congress within 18 months of enactment. The reports may include specific recommendations for legislative or regulatory action regarding the treatment of hybrid capital and access to credit by small depository institutions, indicating that there may be some flexibility in the Collins Amendment requirements, although such studies will be published after the Basel III standards are scheduled to be finalized.
  - **Study on Holding Company Capital Requirements.** The GAO, in consultation with the Federal banking agencies, is required to conduct a study on the use of hybrid capital instruments as a component of Tier 1 capital for banking institutions and bank holding companies. The study must consider, among other things, whether disqualifying trust preferred instruments could lead to the failure or undercapitalization of existing banking organizations and the international competitive implications prohibiting hybrid capital for Tier 1 capital.
  - **Study on Foreign Bank Intermediate Holding Company Capital Requirements.** The GAO, in consultation with the Federal banking agencies, is required to conduct a study of capital requirements applicable to U.S. intermediate holding companies of foreign banks that are bank or thrift holding companies, taking into account the principle of national treatment and equality of competitive opportunity.
  - **Small Banks Study.** GAO, after consultation with the Federal banking agencies, must conduct a study on the access to capital by insured depository institutions with total consolidated assets of \$5 billion or less.



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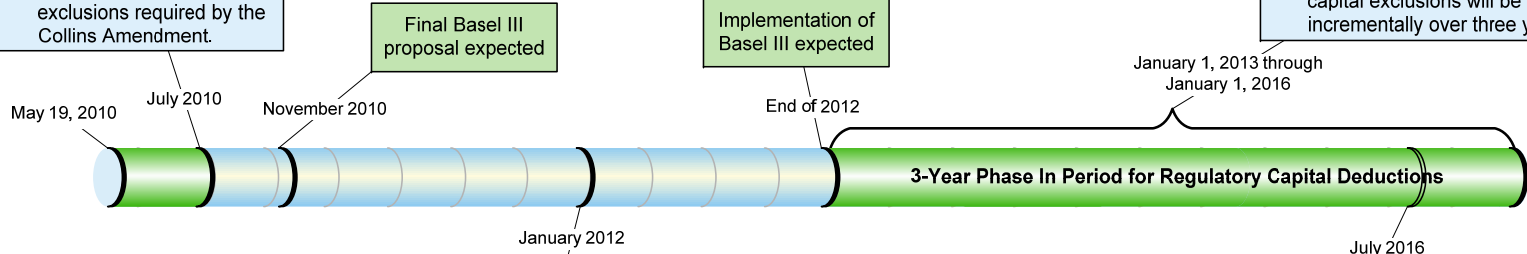
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**Key Point:** Effect of Collins Amendment on U.S. implementation of Basel III standards

**Effective Immediately**

- **Retroactive Effect** – Capital instruments issued on or after May 19, 2010 are immediately subject to the regulatory capital exclusions required by the Collins Amendment.



Final Basel III proposal expected

Implementation of Basel III expected

**Phase in of Regulatory Capital Deductions for Large Institutions**

- With respect to depository institution holding companies with \$15 billion or more in total consolidated assets, regulatory capital exclusions will be phased in incrementally over three years.

**Within 18 Months After Enactment:**

- **Regulations Prescribing Minimum Leverage and Risk-Based Capital Requirements** – applicable to insured depository institutions, insured depository institution holding companies, and systemically important nonbank financial companies.
- **Regulations Prescribing Capital Requirements for Systemically Risky Activities** – including risks arising from:
  - Significant volumes of activity in derivatives, securitized products, financial guarantees, securities borrowing and lending, and repos;
  - Concentrations in assets for which reported values are based on models; and
  - Concentration in market share for any activity that would substantially disrupt financial markets if the institution were forced to unexpectedly cease the activity
- **Report on Holding Company Capital Requirements** – GAO, in consultation with banking regulators, is required to conduct a study on the use of hybrid capital instruments as a component of Tier 1 capital for banking institutions and bank holding companies.
- **Report on Foreign Bank Intermediate Holding Company Capital Requirements** – GAO, in consultation with banking regulators, is required to conduct a study of capital requirements applicable to United States intermediate holding companies of foreign banks.

**5-Year Grandfather of Requirements for Certain Institutions**

- For thrift holding companies, the minimum leverage and capital requirements of the Collins amendment will take effect 5 years after enactment. Regulatory capital exclusions are phased from 2013 to 2016.
- For bank holding company subsidiaries of foreign banking organizations that have relied on the exemption from the Federal Reserve’s capital adequacy guidelines under Supervision and Regulation Letter SR-01-1, the minimum capital and leverage requirements and the regulatory capital exclusions for debt or equity instruments issued **before** May 19, 2010 will take effect 5 years after enactment.