Hinshaw & Culbertson LLP

MEMORANDUM

CHICAGO OFFICE

TO: Hinshaw Clients and Friends

FROM: Tim Sullivan and Mike Morehead

DATE: June 29, 2012

RE: ***FRB, FDIC and OCC (the "Agencies") Issue Proposals that Would Revise Bank Regulatory Capital Requirements and the Risk-Weighted Asset Rules***

Summary

On June 7, 2012, the Agencies issued proposed rules (http://www.federalreserve.gov/newsevents/press/bcreg/20120607a.htm) that would revise bank regulatory capital requirements and the risk-weighted asset rules. These rules represent the most extensive changes to bank capital requirements in recent memory.

The rules will extend large parts of a regulatory capital regime to all U.S. banks and their holding companies, other than the smallest bank holding companies (generally, those with under $500 million in consolidated assets).

Comments on the Rules are due by September 7, 2012. The Rules are expected to go into effect on January 1, 2013. However, in some situations full compliance with the Rules would not be required until January 1, 2019.

The first Rule (the "Capital Rule") would, among other things:

- Revise the definition of regulatory capital components and related calculations, which would include conservative guidelines for determining whether an instrument could qualify as regulatory capital;
- Add common equity Tier 1 capital as a new regulatory capital component;
- Increase the minimum Tier 1 capital ratio requirement;
- Create a capital conservation buffer that would limit payment of capital distributions and certain discretionary bonus payments to executive officers if the institution does not hold enough common equity Tier 1 capital;
- Provide for a transition period for several aspects of the Rule; and
- Incorporate the new and revised regulatory capital requirements into the Prompt Corrective Action rules.

The second Rule (the "Risk-Weighted Asset Rule") would expand the number of risk-weighted categories and increase the required capital for certain categories of assets, including higher-risk residential mortgages and higher-risk construction real estate loans. This Rule would, among other things:

- revise risk weights for residential mortgages based on LTV ratios and certain loan characteristics, assigning risk weights between 35% and 200%;
- increase capital requirements for past-due loans from 100% to 150% and set the risk weight for high volatility commercial real estate loans at 150%; and
- revise the risk-weighted percentage for unused commitments with an original maturity of one year or less from 0 to 20% unless the commitment is unconditionally cancelable by the bank.

The Risk-Weighted Asset Rule will apply to all U.S. banks and savings banks and almost all of their holding companies, although smaller, "non-complex" banking organizations will not need to comply with some of the Rule's requirements. The Rule would be effective on January 1, 2015.

Important Changes

The Capital Rule

The Capital Rule proposes definitions of common equity Tier 1 capital, additional Tier 1 capital, and total capital. Under the proposed definitions, non-cumulative perpetual preferred stock, which now qualifies as Tier 1 capital, would not qualify as common equity Tier 1 capital, but would qualify as additional Tier 1 capital. Cumulative preferred stock and trust preferred securities would not qualify as Tier 1 capital of any kind but may qualify as Tier 2 capital. Generally, an instrument that allows the accumulation of interest would not be considered Tier 1 capital. The revision may impact outstanding trust preferred securities in that it may permit or require a call or redemption of these securities.

Under the Capital Rule revisions, other hybrid or innovative capital instruments will probably not qualify as common equity Tier 1 capital. Some of these instruments may qualify as additional Tier 1 capital.

Instruments that are accounted for as liabilities under GAAP would not qualify as additional Tier 1 capital. For an instrument to qualify as additional Tier 1 capital, it must be accounted for as equity under GAAP.

The Capital Rule creates a "capital conservation buffer." The buffer would limit an institution's ability to make "capital distributions" and "discretionary bonus payments" to executive officers unless the organization has sufficient capital over and above its minimum capital requirements. In effect this provision requires that an institution maintain the following ratios: common equity Tier 1 – 7%; Tier 1 capital – 8.5%; and Tier 1 leverage ratio – 10.5% in order to be able to make such payments.

Risk-Weighted Asset Rule

Under the Risk-Weighted Assets Rule, residential mortgages 1-4 would be separated into two risk categories based on certain product and underwriting characteristics:

- "category 1 residential mortgage exposures" and
- "category 2 residential mortgage exposures".

Category 1 residential mortgage exposures would generally include traditional, first-lien, prudently underwritten mortgage loans. Category 2 residential mortgage exposures would generally include junior-liens and non-traditional mortgage products.

Category 1 mortgages would be assigned risk weights from 45% to 100% while category 2 mortgages would be assigned risk weights of 50% to 200%.

The Rule would assign a 150% risk weight to high volatility commercial real estate loans ("HVCRE"). An HVCRE is defined as a credit facility that finances or has financed the acquisition, development, or construction (ADC) of real property, unless the facility finances:

- One- to four-family residential properties; or
- Commercial real estate projects in which:
  - The LTV ratio is less than or equal to the applicable maximum supervisory LTV ratio;
  - The borrower has contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid development expenses out-of-pocket) of at least 15% of the real estate's appraised "as completed" value; and
  - The borrower contributed the amount of capital required by this definition before funds have been advanced under the credit facility, and the capital contributed by the borrower, or internally generated by the project, is contractually required to remain in the project throughout the life of the project. The life of a project concludes only when the credit facility is converted to permanent financing or is sold or paid in full. Permanent financing may be provided by the organization that provided the ADC facility as long as the permanent financing conforms with the organization's underwriting criteria for long-term mortgage loans.

A 150% risk weight would be assigned to loans and other exposures that are 90 days or more past due or on nonaccrual status that are not guaranteed or secured as provided in the Rule. This would apply to all loans except for the following:

- 1-4 family residential exposures (1-4 family loans over 90 days past due and are in Category 2 and would be risk weighted as described below in **Risk-Weighted Asset Rule --** *1-4 Family Residential Mortgage Loans*.)

- A sovereign exposure where the sovereign has experienced a sovereign default.

The risk-weighted percentage for unused commitments would increase from 0 to 20% unless the commitment is unconditionally cancelable by the bank.

Capital Rule

The Capital Rule applies to banks, savings associations and savings and loan holding companies of any size and to bank holding companies with consolidated assets of $500 million or more. The Rule increases both the quantity and quality of capital required. If adopted, this Rule would revise certain capital definitions and would require most community banks to maintain:

- a minimum common equity Tier 1 capital ratio of 4.5% of risk-weighted assets (a new requirement);

- a minimum total Tier 1 capital ratio of 6% of risk-weighted assets (increased from 4%);

- a minimum total (Tier 1 and Tier 2) capital ratio of 8% of risk-weighted assets (unchanged);

- a minimum Tier 1 leverage ratio of 4% of unadjusted assets; and

- a capital conservation buffer of common equity Tier 1 capital in an amount above the minimum risk-based capital requirements equal to 2.5% of total risk weight assets as discussed below **– Capital Conservation Buffer**.

The Capital Rule would be implemented over a transition period as discussed below – **Transitional Periods**.

The Prompt Corrective Action rules would be amended to incorporate the revised regulatory capital requirements as discussed below **– Prompt Corrective Action**.

Revisions to the Minimum Capital Requirements

This Rule proposes definitions of common equity Tier 1 capital, additional Tier 1 capital, and total capital. These definitions would alter the existing definition of capital by imposing, among other requirements, additional constraints on including of minority interests, mortgage servicing assets (“MSAs”), deferred tax assets (“DTAs”) and certain investments in unconsolidated financial institutions in regulatory capital. In addition, the Rule would require that most regulatory capital deductions be made from common equity Tier 1 capital. Most of a banking organization’s accumulated other comprehensive income be included in regulatory capital.

Definition of Capital

The definitions of the following regulatory capital components: common equity Tier 1 capital, additional Tier 1 capital, and Tier 2 capital, are summarized below.

Under the proposed definitions, non-cumulative perpetual preferred stock, which now qualifies as Tier 1 capital, would not qualify as common equity Tier 1 capital, but would qualify as additional Tier 1 capital. Cumulative preferred stock and trust preferred securities would not qualify as Tier 1 capital of any kind but may qualify as Tier 2 capital. Generally, an instrument that allows the accumulation of interest would not be considered Tier 1 capital. The revision may impact outstanding trust preferred securities in that it may permit or require a call or redemption of these securities.

Under the revisions, other hybrid or innovative capital instruments will probably not qualify as common equity Tier 1 capital. Some of these instruments may qualify as additional Tier 1 capital.

Instruments that are accounted for as liabilities under GAAP would not qualify as additional Tier 1 capital; for an instrument to qualify as additional Tier 1 capital, it must be accounted for as equity under GAAP.

Common Equity Tier 1 Capital

Common equity Tier 1 capital would be defined as the sum of the common equity Tier 1 elements, less applicable regulatory adjustments and deductions. Qualifying common equity Tier 1 capital would have to satisfy 13 criteria designed to assure that the capital is perpetual and is available to absorb losses.

Among other things, a common equity Tier 1 capital must have no maturity date, must limit capital distributions on the instrument to distributions that are paid out of net income and retained earnings and must allow the cancellation of dividends without triggering an event of default. The instrument can only be redeemed with Agency approval, must not have provisions that suggest or indicate the issuer will redeem the instrument and must be treated as equity in accordance with GAAP; the purchase of the instrument cannot be financed directly or indirectly by the issuer.

The Agencies anticipate that voting common equity will be the dominant element of common equity Tier 1 capital. If an institution issues non-voting common stock, it should ensure that the stock is identical to its voting common in all other aspects.

Common equity Tier 1 capital elements would include:

- Common stock instruments (that satisfy specified criteria in the Rule) and related surplus (net of any treasury stock);
- Retained earnings;
- Accumulated other comprehensive income ("AOCI"); and

- Common equity minority interests (as defined in the Rule) subject to the limitations outlined in Rule as discussed below – *Minority Interests in Subsidiaries*.

Additional Tier 1 Capital

Additional Tier 1 capital would be defined as the sum of additional Tier 1 capital elements and related surplus, less applicable regulatory adjustments and deductions. Additional Tier 1 capital would have to comply with 14 criteria.

Additional Tier 1 capital instruments, among other things, must be subordinated to depositors, general creditors and subordinated debt holders, must not be secured, must not contain a dividend step-up feature that would encourage redemption, must not carry a maturity date, must not be redeemable without Agency approval, must allow the cancellation of dividends without triggering a default and must be treated as equity under GAAP.

Additional Tier 1 capital elements would include:

- Noncumulative perpetual preferred stock (that satisfy the 14 criteria) and related surplus;

- Tier 1 minority interests (as defined below), subject to limitations described in the Rule, not included in the common equity Tier 1 capital; and

- Instruments that currently qualify as Tier 1 capital under the Agencies' general risk-based capital rules and that were issued under the Small Business Job's Act of 2010 (SBLF), or, prior to October 4, 2010, under the Emergency Economic Stabilization Act of 2008 (TARP).

Tier 2 Capital

Tier 2 capital would consist of the sum of Tier 2 capital elements and related surplus, less regulatory adjustments and deductions. Tier 2 capital must satisfy 11 separate criteria designed to assure adequate subordination and stability of availability. Tier 2 capital instruments, among other things, must not be secured, must not contain a dividend step-up feature designed to encourage redemption, must not permit the holder to call the instrument except in situations like bankruptcy and must be redeemable only with the prior approval of an Agency; the purchase of the instrument cannot be financed directly or indirectly by the issuer. The Tier 2 capital elements would include:

- Subordinated debt and preferred stock which will include most of the subordinated debt currently included in Tier 2 capital according to the Agencies' existing risk-based capital rules;

- Total capital minority interest (as defined below), subject to the limitations described in the Rule, and not included in Tier 1 capital;

- Allowance for loan and lease losses not exceeding 1.25% of the total risk-weighted assets; and

- Instruments that currently qualify as Tier 2 capital under the Agencies' general risk-based capital rules and that were issued under the Small Business Job's Act of 2010 (SBLF), or, prior to October 4, 2010, under the Emergency Economic Stabilization Act of 2008 (TARP).

Minority Interests in Subsidiaries

The Rule would limit the amount of a minority interest in a subsidiary that may be included in regulatory capital.

Minority interests would be classified as a "common equity Tier 1" or "total capital minority interest" depending on the underlying capital instrument and on the type of subsidiary issuing such instrument.

The common equity Tier 1 minority interest is defined to mean any minority interest arising from the issuance of common shares by a fully consolidated subsidiary. This interest would be recognized in common equity Tier 1 only if both of the following are true:

- The instrument giving rise to the minority interest would, if issued by the banking organization itself, meet all of the criteria for common stock instruments; and

- The subsidiary is itself a depository institution.

If not recognized in common equity Tier 1, the minority interest may be eligible for inclusion in additional Tier 1 capital or Tier 2 capital.

The amount of minority interest that may be included in the consolidated capital would be based on the amount of capital held by the consolidated subsidiary, relative to the amount of capital that the subsidiary would have to hold in order to avoid any restrictions on capital distributions and discretionary bonus payments under the capital conservation buffer framework discussed below.

Adjustments and Deductions from Capital

Regulatory deductions from common equity Tier 1 capital

The Capital Rule would require that the following be deducted from the sum of the common equity Tier 1 capital elements:

- Goodwill and all other intangible assets (other than MSAs), net of any associated deferred tax liabilities (DTLs).

- DTAs that arise from operating loss and tax credit carryforwards net of any valuation allowance and net of DTLs.

- After tax gain-on-sale associated with a securitization exposure.

- Defined benefit pension fund assets (except an insured depository institution's own defined benefit pension plan), net of any associated deferred tax liability. However, this deduction may be reduced if approved by the primary federal regulator.

- The DTLs for this deduction exclude those deferred tax liabilities that have already been netted against DTAs.

Adjustments to common equity Tier 1 capital

The following associated unrealized gains would have to be deducted and the associated unrealized losses would have to be added to the sum of common equity Tier 1 capital elements:

- Unrealized gains and losses on cash flow hedges included in AOCI that relate to the hedging of items that are not recognized at fair value on the balance sheet.

- Unrealized gains and losses that have resulted from changes in the fair value of liabilities that are due to changes in the banking organization's own credit risk.

Additional deductions from regulatory capital

To avoid double counting of capital, the following deductions would have to be made with respect to investments by an entity in its own capital instruments:

- Investments in the organization's own common stock instruments (including any contractual obligation to purchase), whether held directly or indirectly, would have to be deducted from the common equity Tier 1 elements.

- Investments in (including any contractual obligation to purchase) the organization's own additional Tier 1 capital instruments, whether held directly or indirectly, would have to be deducted from additional Tier 1 capital elements.

- Investments in (including any contractual obligation to purchase) the organization's own Tier 2 capital instruments, whether held directly or indirectly, would have to be deducted from Tier 2 capital elements.

Corresponding deduction approach

The Rule would require that the corresponding deduction approach be used to calculate the required deductions from regulatory capital for:

- Reciprocal cross-holdings;

- Non-significant investments in the capital of unconsolidated financial institutions; and

- Non-common stock significant investments in the capital of unconsolidated financial institutions.

For purposes of the Rule, an instrument is held reciprocally if the instrument is held pursuant to a formal or informal arrangement to swap, exchange, or otherwise intend to hold each other's capital instruments.

Non-significant investments in the capital of unconsolidated financial institutions that, in the aggregate, exceed 10% of the sum of the organization's common equity Tier 1 capital elements (less all deductions and other regulatory adjustments required under the Rule) would have to be deducted.

All significant investments not in the form of common stock would have to be deducted.

Such deductions would be made from the same component of capital for which the underlying instrument would qualify if it were issued by the organization itself. In addition, if a sufficient amount of such component of capital is available to effect the deduction, the shortfall will be deducted from the next higher (that is, more subordinated) component of regulatory capital. For example, if the exposure may be deducted from additional Tier 1 capital but the organization does not have sufficient additional Tier 1 capital, it would take the deduction from common equity Tier 1 capital.

Threshold Deductions

A banking organization would have to deduct from common equity Tier 1 capital elements each of the following assets (together, the threshold deduction items) that, individually, are above 10% of the sum of the organization's common equity Tier 1 capital elements, less all required adjustments and deductions required under the Rule (the 10% common equity deduction threshold):

- DTAs arising from temporary differences that the organization could not realize through net operating loss carrybacks, net of any associated valuation allowance, and DTLs, subject to the following limitations:

    ○ Only the DTAs and DTLs that relate to taxes levied by the same taxation authority and that are eligible for offsetting by that authority may be offset for purposes of this deduction.

    ○ The DTLs offset against DTAs must exclude amounts that have already been netted against other items that are either fully deducted (such as goodwill) or subject to deduction (such as MSA).

- MSAs, net of associated DTLs.

- Significant investments in the capital of unconsolidated financial institutions in the form of common stock.

Additional deductions will be made if the aggregate amount of the threshold deduction items exceed 15% of the organization's common equity Tier 1 capital net of all deductions.

Capital Conservation Buffer

The Capital Rules would create a capital conservation buffer that would be phased in starting in 2016, and would require additional regulatory capital of 2.5% on a fully phased-in basis by January 1, 2019. A banking organization's ability to make "capital distributions" and "discretionary bonus payments" (as defined below) to executive officers and persons with commensurate responsibilities would be limited unless it has sufficient capital over and above its minimum capital requirements.

A banking organization's capital conservation buffer would be the smallest of the following ratios: (a) its common equity Tier 1 capital ratio (in percent) minus 4.5%; (b) its Tier 1 capital ratio (in percent) minus 6%; and (c) its total capital ratio (in percent) minus 8%.

In effect, an institution would have to maintain the following ratios: common equity Tier 1 – 7%; Tier 1 capital – 8.5%; and Tier 1 leverage ratio – 10.5% if it wanted to make such payments.

To the extent the buffer falls below these thresholds, the maximum payout amount for capital distributions and discretionary bonus payments (calculated as the maximum payout ratio multiplied by the sum of "eligible retained income") would decline as indicated in the following table:

Capital Conservation Buffer **(as a percentage of risk-weighted assets)**	**Maximum payout ratio (as a percentage or "eligible retained income")**
Greater than 2.5%	No payout limitation applies
Less than or equal to 2.5% and greater than 1.875%	60%
Less than or equal to 1.875% and greater than 1.25%	40%
Less than or equal to 1.25% and greater than 0.625%	20%
Less than or equal to 0.625%	0%

A "capital distribution" is defined as: (i) a reduction of Tier 1 capital (by repurchase or otherwise); (ii) a reduction of Tier 2 capital (by repurchase or early redemption or otherwise); (iii) a dividend on Tier 1 capital; (iv) a dividend or interest payment on Tier 2 (where the banking organization has discretion to suspend that payment); and (v) any substantively similar transaction.

A “discretionary bonus payment” to an executive officer (generally defined as a titled executive or person with commensurate executive responsibilities) is any payment where (i) the banking organization retains discretion as to whether to pay or the amount of payment, (ii) the amount paid is determined without prior promise to, or agreement with, the officer, and (iii) the executive officer has no contractual right to the payment.

“Eligible retained income” is defined as net income for the four calendar quarters preceding the current calendar quarter, based on the most recent quarterly regulatory reports, net of any capital distributions and associated tax effects not already reflected in net income.

The maximum payout amount for the current calendar quarter would be equal to the eligible retained income, multiplied by the applicable maximum payout ratio in the above table.

Capital distributions or certain discretionary bonus payments could not be made during the current calendar quarter if:

- its eligible retained income is negative; and
- its capital conservation buffer ratio was less than 2.5% as of the end of the previous quarter.

The Agencies may place additional limitations on capital distributions.

Transitional Periods

Almost all of the Capital Rule requirements would be phased in by January 1, 2019.

A banking organization will have to address the Capital’s Rule different phase-in and phase-out timelines and specifications. Because there are different transition requirements for the capital ratios, the regulatory deductions and non-qualifying capital instruments and the Risk-Weighted Asset Rule becomes effective on January 1, 2015, an institution will have to carefully address its capital issues when complying with the Tier 1 and Tier 2 capital requirements during these transition periods.

Minimum Capital Ratios

The minimum common equity and Tier 1 capital ratios would be implemented in beginning in the 2013 calendar year with a common equity requirement of 3.5% and a Tier 1 requirement of 4.5% for 2013; 4.0% and 5.5%, respectively, for the 2014. The ratios would be fully effective (4.5% and 6.0%, respectively) for the 2015 and thereafter.

Regulatory Capital Adjustments and Deductions

The required regulatory capital adjustments and deductions will be implemented beginning in 2013 and will be fully phased in by 2018. Deductions for goodwill from common equity Tier 1 capital, however, and must be fully deducted beginning in the calendar year 2013.

Elimination of Non-qualifying Capital Instruments

For organizations with more than $15 billion in assts, the transition period for non-qualifying capital instruments is a straight-line percentage inclusion (75% of non-qualifying instruments may be included in Tier 1 or Tier 2 capital in 2013, 50% may be included in 2014, and 25% in 2015), with full effectiveness in 2016.

For smaller organizations, the transition period begins (on a straight-line basis) in 2013 but is not fully phased in until 2022.

Capital Conservation Buffers

The capital conservation buffer requirements become fully effective on January 1, 2019. The buffer would be established in 2016 at 0.625%; it then would increase on a straight-line basis (an additional o.625% each year) up to 2.5% in 2019. These requirements must be satisfied in order to avoid restrictions on capital distributions and discretionary payouts during the transition period. For example, in 2017, the buffer would be 1.25% and if the institution's buffer was less than 1.25% but more than 0.938%, it could only pay-out 60%. of its eligible retained income.

Prompt Corrective Action

The conforming changes to the Agencies' PCA regulations would be effective on January 1, 2015.

The PCA capital category thresholds would be revised to reflect the new capital ratio requirements with the common equity Tier 1 capital ratio being added as a PCA capital category threshold. In addition, the existing definition of tangible equity would now be defined as Tier 1 capital (composed of common equity Tier 1 and additional Tier 1 capital) plus any outstanding perpetual preferred stock (including related surplus) that is not already included in Tier 1 capital.

PCA Capital Category	**Threshold Ratios**			
	Total Risk-based Capital ratio	**Tier 1 Risk-based Capital ratio**	**Common Equity Tier 1 Risk-based Capital ratio**	**Tier 1 Leverage ratio**
Well capitalized	10%	8%	6.5%	5%
Adequately capitalized	8%	6%	4.5%	4%
Undercapitalized	<8%	<6%	<4.5%	<4%
Significantly undercapitalized	<6%	<4%	<3%	<3%
Critically undercapitalized	Tangible Equity/Total Assets </=2%			

The Risk-Weighted Asset Rule

Applicability

The second Rule (the "Risk-Weighted Asset Rule") would expand the number of risk-weighted categories and increase the required capital for certain categories of assets, including higher-risk residential mortgages, higher-risk construction real estate loans and certain exposures related to securitizations. This Rule would, among other things:

- revise risk weights for residential mortgages based on LTV ratios and certain loan characteristics, assigning risk weights between 35% and 200%;

- increase capital requirements for past-due loans from 100% to 150% and set the risk weight for high volatility commercial real estates at 150%; and

- revise the risk-weighted percentage for unused commitments with an original maturity of one year or less from 0 to 20% unless the commitment is unconditionally cancelable by the bank.

It should be noted that the Agencies have in the past assigned higher percentages for certain assets at specific institutions. The Rule does not change these existing requirements or prohibit the Agencies from issuing such higher percentages in the future.

Effective Date

If adopted, the Rule will take effect on January 1, 2015. The Rule can be implemented earlier. The Rule does not provide for any transition period.

Zero Percent Risk-Weighted Items

The following would receive a zero percent risk weight under the Rule:

- Cash;
- Direct and unconditional claims on the U.S. government, its central bank, or a U.S. government agency;
- Exposures unconditionally guaranteed by the U.S. government, its central bank, or a U.S. government agency;
- Claims on certain supranational entities (such as the International Monetary Fund) and certain multilateral development banking organizations; and
- Claims on and exposures unconditionally guaranteed by sovereign entities that meet certain criteria.

20% Risk Weighted Items

A 20% risk weight would be assigned to the following under the Rule:

- Cash items in the process of collection;

- Exposures conditionally guaranteed by the U.S. government, its central bank, or a U.S. government agency;
- Claims on government sponsored entities (“GSEs”);
- Claims on U.S. depository institutions and NCUA-insured credit unions;
- General obligation claims on, and claims guaranteed by the full faith and credit of state and local governments (and any other public sector entity, as defined in the Rule) in the United States;
- Claims on and exposures guaranteed by foreign banks and public sector entities if the sovereign of incorporation of the foreign bank or public sector entity meets certain criteria; and
- unused commitments with an original maturity of one year or less from 0 to 20% unless the commitment is unconditionally cancelable by the bank

50% Risk-Weighted Assets

A 50% risk weight would be assigned the following under the Rule:

- “Statutory” multifamily mortgage loans meeting certain criteria set out in Section 618(2) and (2) of Resolution Trust Corporation Refinancing, Restructuring and Improvement Act of 1991 (“RTCRRI”) and in the Rule;
- Presold residential construction loans meeting certain criteria set out in Section 618(b)(1) of RTCRRI and in the Rule;
- Revenue bonds issued by state and local governments in the United States; and
- Claims on and exposures guaranteed by sovereign entities, foreign banks, and foreign public sector entities that meet certain criteria.

As required by federal law, the criteria for multifamily loans and presold residential construction loans are generally the same as in the existing general risk-based capital rules. The Rule would assign a 100% risk weight to presold construction loans where the contract is cancelled.

1-4 Family Residential Mortgage Loans

Residential mortgages 1-4 would be separated into two risk categories based on certain product and underwriting characteristics:

- “category 1 residential mortgage exposures” and
- “category 2 residential mortgage exposures”.

Category 1 residential mortgage exposures would generally include traditional, first-lien, prudently underwritten mortgage loans. Category 2 residential mortgage exposures would generally include junior-liens and non-traditional mortgage products.

FHA and VA loans would continue to receive zero percent risk weight due to their unconditional government guarantee.

Calculation of LTV

The value of the property is the lesser of the acquisition cost (for a purchase transaction) or the estimate of the property's value at the origination of the loan or the time of restructuring. All estimates of a property's value must be based on an appraisal or evaluation of the property that meets the requirements of the primary federal supervisor's appraisal regulations.

Because of the problems the Agencies perceive with mortgage providers, the Rule would not recognize private mortgage insurance for purposes of calculating the LTV ratio. The LTV levels shown below would represent only the borrower's equity in the mortgaged property.

The table below shows the proposed risk weights for 1-4 family residential mortgage loans, based on the LTV ratio and risk category of the exposure:

LTV ratio (in %)	Risk weight for category 1 residential mortgage exposures (percent)	Risk weight for category 2 residential mortgage exposures (percent)
Less than or equal to 60	35	100
Greater than 60 and less than or equal to 80	50	100
Greater than 80 and less than or equal to 90	75	150
Greater than 90	100	200

Category 1 Criteria

A residential mortgage with the following characteristics would be deemed a category 1 residential mortgage exposure:

- The term of the mortgage loan does not exceed 30 years;
- The terms of the mortgage loan provide for regular periodic payments that do not:
  - result in an increase of the principal balance;
  - allow the borrower to defer repayment of principal of the residential mortgage exposure; or
  - result in a balloon payment;
- The standards used to underwrite the residential mortgage loan:
  - took into account all of the borrower's obligations, including for mortgage obligations, principal, interest, taxes, insurance, and assessments; and
  - resulted in a conclusion that the borrower is able to repay the loan using:
    - the maximum interest rate that may apply during the first five years after the date of the closing of the residential mortgage loan; and

- the amount of the residential mortgage loan as of the date of the closing of the transaction;

- The terms of the residential mortgage loan allow the annual rate of interest to increase no more than 2% in any twelve month period and no more than 6% over the life of the loan;
- For a first-lien HELOC, the borrower must be qualified using the principal and interest payments based on the maximum contractual exposure under the terms of the HELOC;
- The determination of the borrower's ability to repay is based on documented, verified income;
- The residential mortgage loan is not 90 days or more past due or on non-accrual status; and
- The residential mortgage loan is not a junior-lien residential mortgage exposure.

Category 2 Criteria

All residential mortgages that are not category 1 residential mortgages and that are not guaranteed by the U.S. government are deemed category 2 mortgages.

Calculation of Loan Amount

The loan amount for a first-lien residential mortgage would be the maximum contractual principal amount of the loan. For a traditional mortgage loan where the loan balance will not increase under the terms of the mortgage, the loan amount is the current loan balance.

Where the balance may increase under the terms of the mortgage, such as a pay-option adjustable loan that can negatively amortize or for a HELOC, the loan amount is the maximum contractual principal amount of the loan.

The loan amount for a junior-lien mortgage would be the maximum contractual principal amount of the loan plus the maximum contractual principal amounts of all senior loans secured by the same residential property on the date of origination of the junior-lien residential mortgage.

Two or More Mortgages

When a first mortgage and junior-lien mortgage are held by one entity on the same residential property and there is no intervening lien, the combined exposure as a single first-lien mortgage exposure provided each loan meets all of the category 1 characteristics listed above.

If two or more mortgage loans are held by the same entity on the same residential property, and one of the loans is category 2 (e.g., it did not meet all of the category 1 characteristics listed above), then all of the loans on the property would be treated as category 2.

Restructured Mortgages

Restructured and modified mortgages would be assigned risk weights based on their LTVs and classification as category 1 or category 2 residential mortgage exposures; the classifications would be based on the modified contractual terms. If the LTV is not updated at the time of modification or restructuring, a category 1 residential mortgage would receive a risk weight of 100% and a category 2 residential mortgage would receive a risk weight of 200%.

Loans modified or restructured under the Treasury's HAMP program would not be considered modified or restructured for the purposes of the Rule.

Past Due Exposures

A 150% risk weight would be assigned to loans and other exposures that are 90 days or more past due or on nonaccrual status and that are not guaranteed or secured as provided in the Rule. This would apply to all loans except for the following:

- 1-4 family residential exposures (1-4 family loans over 90 days past due and are in Category 2 and would be risk weighted as described above in *1-4 Family Residential Mortgage Loans*.)

- A sovereign exposure where the sovereign has experienced a sovereign default.

High Volatility Commercial Real Estate Loans

A 150% risk weight would be assigned to HVCRE exposures. An HVCRE exposure is defined as a credit facility that finances or has financed the acquisition, development, or construction (ADC) of real property, unless the facility finances:

- One- to four-family residential properties; or

- Commercial real estate projects in which:

    - The LTV ratio is less than or equal to the applicable maximum supervisory LTV ratio;

    - The borrower has contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid development expenses out-of-pocket) of at least 15% of the real estate's appraised "as completed" value; and

    - The borrower contributed the amount of capital required by this definition before funds have been advanced under the credit facility, and the capital contributed by the borrower, or internally generated by the project, is contractually required to remain in the project throughout the life of the project. The life of a project concludes only when the credit facility is converted to permanent financing or is sold or paid in full. Permanent financing may be provided by the banking organization that provided the ADC facility as long as the permanent financing conforms with the banking organization's underwriting criteria for long-term mortgage loans.

A commercial real estate loan that is not treated as an HVCRE would be treated as a corporate exposure.

Commercial Loans/Corporate Exposures

The Rule would assign a 100% risk weight to all corporate exposures. The definition of a corporate exposure would exclude exposures that are specifically covered elsewhere in the proposal, such as HVCRE, pre-sold residential construction loans, and statutory multifamily mortgages.

Consumer Loans and Credit Cards

Consumer loans and credit cards would continue to receive a 100% risk weight.

Other Assets and Exposures

Where the Rule does not assign a specific risk weight to an asset or exposure type, the applicable risk weight would be 100%. For example, premises, fixed assets, and other real estate owned receive a risk weight of 100%.

Other Risk-Weights

The Rule assigns risk weights to a number of other assets, including off-balance sheet items, OTC derivative contracts, securitization exposures, equity exposures and equity exposures to investment funds.