Issue of Concern: Requiring Unrealized Gains and Losses Flowing Through Capital

The Basel III NPR proposed that unrealized gains and losses on a banking organization's Available-For-Sale (AFS) securities "flow through" to common equity Tier 1(CET1). Under the current risk-based capital rules, unrealized gains and losses that exist in accumulated other comprehensive income on AFS debt securities are not included in regulatory capital.

Why it is an Issue:

Allowing unrealized gains and losses to flow through capital would:

- Negatively impact the ability of banking organizations to contribute to the economic recovery in a rising interest rate environment. With the inclusion of unrealized losses of AFS securities in CET1, rising interest rates would put downward pressure on banking organizations' capital levels, potentially causing banking organizations to reduce the growth of or shrink their securities portfolios considerably to maintain capital ratios at desired or required levels.
- Because of the substantial volatility introduced into CET1 and Tier 1 capital, flowing unrealized gains and losses through to capital would force banks to maintain ratios of both CET1 to risk-weighted assets and Tier 1 capital to risk-weighted assets substantially above the levels that would otherwise apply in order to avoid the sanctions applicable to banks that fall into the capital conservation buffer.
- Discourage banks from engaging in routine activities used as an important asset-liability management tool.

Treatment under the Final Rule:

In the final rule, the banking agencies recognized the significant burdens that flowing unrealized gains and losses through capital would cause. As such, the final will allow most banks a one-time choice to include, or not, unrealized gains and losses on available-for-sale securities in capital. This election must be made at the first filing of the Call Report or FR-Y9 filed after an institution becomes subject to the final rule (or for the first quarter 2015 filing). Advanced approaches banks are not eligible for the opt-out and, as such, must flow unrealized gains and losses through capital.