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## Part III

### Department of the Treasury

Office of the Comptroller of the Currency  
12 CFR Part 3

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### Federal Reserve System

12 CFR Part 217

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### Federal Deposit Insurance Corporation

12 CFR Part 324

Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets;  
Market Discipline and Disclosure Requirements; Proposed Rule

**DEPARTMENT OF THE TREASURY****Office of the Comptroller of the Currency****12 CFR Part 3**

[Docket ID OCC–2012–0009]

RIN 1557–AD46

**FEDERAL RESERVE SYSTEM****12 CFR Part 217**

[Regulations H, Q, and Y; Docket No. R–1442]

RIN 7100 AD 87

**FEDERAL DEPOSIT INSURANCE CORPORATION****12 CFR Part 324**

RIN 3064–AD96

**Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements**

**AGENCY:** Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; and the Federal Deposit Insurance Corporation.

**ACTION:** Joint notice of proposed rulemaking.

**SUMMARY:** The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the agencies) are seeking comment on three notices of proposed rulemaking (NPRs) that would revise and replace the agencies' current capital rules.

This NPR (Standardized Approach NPR) includes proposed changes to the agencies' general risk-based capital requirements for determining risk-weighted assets (that is, the calculation of the denominator of a banking organization's risk-based capital ratios). The proposed changes would revise and harmonize the agencies' rules for calculating risk-weighted assets to enhance risk-sensitivity and address weaknesses identified over recent years, including by incorporating certain international capital standards of the Basel Committee on Banking Supervision (BCBS) set forth in the standardized approach of the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (Basel II), as revised by the BCBS between 2006 and 2009, and other proposals addressed in recent consultative papers of the BCBS.

In this NPR, the agencies also propose alternatives to credit ratings for calculating risk-weighted assets for certain assets, consistent with section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). The revisions include methodologies for determining risk-weighted assets for residential mortgages, securitization exposures, and counterparty credit risk. The changes in the Standardized Approach NPR are proposed to take effect on January 1, 2015, with an option for early adoption. The Standardized Approach NPR also would introduce disclosure requirements that would apply to top-tier banking organizations domiciled in the United States with \$50 billion or more in total assets, including disclosures related to regulatory capital instruments. In connection with the proposed changes to the agencies' capital rules in this NPR, the agencies are also seeking comment on the two related NPRs published elsewhere in today's **Federal Register**. The two related NPRs are discussed further in the **SUPPLEMENTARY INFORMATION**.

**DATES:** Comments must be submitted on or before October 22, 2012.

**ADDRESSES:** Comments should be directed to:

*OCC:* Because paper mail in the Washington, DC area and at the OCC is subject to delay, commenters are encouraged to submit comments by the Federal eRulemaking Portal or email, if possible. Please use the title "Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements" to facilitate the organization and distribution of the comments. You may submit comments by any of the following methods:

- *Federal eRulemaking Portal—*"regulations.gov": Go to <http://www.regulations.gov>. Click "Advanced Search." Select "Document Type" of "Proposed Rule," and in "By Keyword or ID" box, enter Docket ID "OCC–2012–0009," and click "Search." If proposed rules for more than one agency are listed, in the "Agency" column, locate the notice of proposed rulemaking for the OCC. Comments can be filtered by Agency using the filtering tools on the left side of the screen. In the "Actions" column, click on "Submit a Comment" or "Open Docket Folder" to submit or view public comments and to view supporting and related materials for this rulemaking action.

- Click on the "Help" tab on the Regulations.gov home page to get information on using Regulations.gov, including instructions for submitting or

viewing public comments, viewing other supporting and related materials, and viewing the docket after the close of the comment period.

- *Email:* [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov).
- *Mail:* Office of the Comptroller of the Currency, 250 E Street SW., Mail Stop 2–3, Washington, DC 20219.
- *Fax:* (202) 874–5274.
- *Hand Delivery/Courier:* 250 E Street SW., Mail Stop 2–3, Washington, DC 20219.

*Instructions:* You must include "OCC" as the agency name and "Docket ID OCC–2012–0009." In general, OCC will enter all comments received into the docket and publish them on the Regulations.gov Web site without change, including any business or personal information that you provide such as name and address information, email addresses, or phone numbers. Comments received, including attachments and other supporting materials, are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

You may review comments and other related materials that pertain to this notice by any of the following methods:

- *Viewing Comments Electronically:* Go to <http://www.regulations.gov>. Click "Advanced search." Select "Document Type" of "Public Submission" and in "By Keyword or ID" box enter Docket ID "OCC–2012–0009," and click "Search." If comments from more than one agency are listed, the "Agency" column will indicate which comments were received by the OCC. Comments can be filtered by Agency using the filtering tools on the left side of the screen.

- *Viewing Comments Personally:* You may personally inspect and photocopy comments at the OCC, 250 E Street SW., Washington, DC 20219. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling (202) 874–4700. Upon arrival, visitors will be required to present valid government-issued photo identification and to submit to security screening in order to inspect and photocopy comments.

- *Docket:* You may also view or request available background documents and project summaries using the methods described above.

*Board:* When submitting comments, please consider submitting your comments by email or fax because paper mail in the Washington, DC area and at the Board may be subject to delay. You may submit comments, identified by

Docket No. R-1442; RIN No. 7100 AD 87, by any of the following methods:

- *Agency Web Site:* <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.

- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments.

- *Email:* [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov). Include docket number in the subject line of the message.

- *Fax:* (202) 452-3819 or (202) 452-3102.

- *Mail:* Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue NW., Washington, DC 20551.

All public comments are available from the Board's Web site at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper form in Room MP-500 of the Board's Martin Building (20th and C Street NW., Washington, DC 20551) between 9 a.m. and 5 p.m. on weekdays.

**FDIC:** You may submit comments by any of the following methods:

- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments.

- *Agency Web site:* <http://www.FDIC.gov/regulations/laws/federal/propose.html>.

- *Mail:* Robert E. Feldman, Executive Secretary, Attention: Comments/Legal ESS, Federal Deposit Insurance Corporation, 550 17th Street NW., Washington, DC 20429.

- *Hand Delivered/Courier:* The guard station at the rear of the 550 17th Street Building (located on F Street), on business days between 7:00 a.m. and 5:00 p.m.

- *Email:* [comments@FDIC.gov](mailto:comments@FDIC.gov).

- *Instructions:* Comments submitted must include "FDIC" and "RIN 3064-AD 96." Comments received will be posted without change to <http://www.FDIC.gov/regulations/laws/federal/propose.html>, including any personal information provided.

**FOR FURTHER INFORMATION CONTACT:**

**OCC:** Margot Schwadron, Senior Risk Expert, (202) 874-6022, David Elkes, Risk Expert, (202) 874-3846, or Mark Ginsberg, Risk Expert, (202) 927-4580, or Ron Shimabukuro, Senior Counsel, Patrick Tierney, Counsel, or Carl Kaminski, Senior Attorney, Legislative and Regulatory Activities Division,

(202) 874-5090, Office of the Comptroller of the Currency, 250 E Street SW., Washington, DC 20219.

**Board:** Anna Lee Hewko, Assistant Director, (202) 530-6260, Thomas Boemio, Manager, (202) 452-2982, or Constance M. Horsley, Manager, (202) 452-5239, Capital and Regulatory Policy, Division of Banking Supervision and Regulation; or Benjamin McDonough, Senior Counsel, (202) 452-2036, April C. Snyder, Senior Counsel, (202) 452-3099, or Christine Graham, Senior Attorney, (202) 452-3005, Legal Division, Board of Governors of the Federal Reserve System, 20th and C Streets NW., Washington, DC 20551. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), (202) 263-4869.

**FDIC:** Bobby R. Bean, Associate Director, [bbean@fdic.gov](mailto:bbean@fdic.gov); Ryan Billingsley, Chief, Capital Policy Section, [rbillingsley@fdic.gov](mailto:rbillingsley@fdic.gov); Karl Reitz, Chief, Capital Markets Strategies Section, [kreitz@fdic.gov](mailto:kreiz@fdic.gov), Division of Risk Management Supervision; David Riley, Senior Policy Analyst, [dariley@fdic.gov](mailto:dariley@fdic.gov), Capital Markets Branch, Division of Risk Management Supervision, (202) 898-6888; or Mark Handzlik, Counsel, [mhandzlik@fdic.gov](mailto:mhandzlik@fdic.gov), Michael Phillips, Counsel, [mphillips@fdic.gov](mailto:mphillips@fdic.gov), Greg Feder, Counsel, [gfeder@fdic.gov](mailto:gfeder@fdic.gov), or Ryan Clougherty, Senior Attorney, [rclougherty@fdic.gov](mailto:rclougherty@fdic.gov), Supervision Branch, Legal Division, Federal Deposit Insurance Corporation, 550 17th Street NW., Washington, DC 20429.

**SUPPLEMENTARY INFORMATION:** The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the agencies) are seeking comment on three notices of proposed rulemaking (NPRs) that would revise and replace the agencies' current capital rules.

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Measurement and Capital Standards: A Revised Framework" (Basel II), as revised by the BCBS between 2006 and 2009, and other proposals addressed in recent consultative papers of the BCBS.

In this NPR, the agencies also propose alternatives to credit ratings for calculating risk-weighted assets for certain assets, consistent with section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). The revisions include methodologies for determining risk-weighted assets for residential mortgages, securitization exposures, and counterparty credit risk. The changes in this Standardized Approach NPR are proposed to take effect on January 1, 2015, with an option for early adoption. The Standardized Approach NPR also would introduce disclosure requirements that would apply to top-tier banking organizations domiciled in the United States with \$50 billion or more in total assets, including disclosures related to regulatory capital instruments.

In connection with the proposed changes to the agencies' capital rules in this NPR, the agencies are also seeking comment on the two related NPRs published elsewhere in today's **Federal Register**. In the notice titled "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Prompt Corrective Action, and Transition Provisions" (Basel III NPR), the agencies are proposing to revise their minimum risk-based capital requirements and criteria for regulatory capital, as well as establish a capital conservation buffer framework, consistent with Basel III.

The proposals in this NPR and the Basel III NPR would apply to all banking organizations that are currently subject to minimum capital requirements (including national banks, state member banks, state nonmember banks, state and federal savings associations, and top-tier bank holding companies domiciled in the United States not subject to the Board's Small Bank Holding Company Policy Statement), as well as top-tier savings and loan holding companies domiciled in the United States (together, banking organizations).

In the notice titled "Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule," (Advanced Approaches and Market Risk NPR) the agencies are proposing to revise the advanced approaches risk-based capital rules, which are applicable only to the largest internationally active banking organizations, consistent with Basel III

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<sup>1</sup> Sections marked with an asterisk generally would not apply to less complex banking organizations.

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### I. Introduction and Overview

The Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the agencies) are proposing comprehensive revisions to their regulatory capital framework through three concurrent notices of proposed rulemaking (NPRs). In this NPR (Standardized Approach NPR), the agencies are proposing to revise certain aspects of the general risk-based capital requirements that address the calculation of risk-weighted assets. The agencies believe the proposed changes included in this NPR would both enhance the overall risk-sensitivity of the calculation of a banking organization's total risk-weighted assets and be consistent with relevant provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).<sup>2</sup> Although many

<sup>2</sup> Public Law 111–203, 124 Stat. 1376 (2010).

of the proposed changes included in this NPR are not specifically included in the Basel capital framework, the agencies believe that these proposed changes are generally consistent with the goals of the international framework.

This NPR contains a standardized approach for determining risk-weighted assets. This NPR would apply to all banking organizations currently subject to minimum capital requirements, including national banks, state member banks, state nonmember banks, state and federal savings associations, top-tier bank holding companies domiciled in the United States not subject to the Board's Small Bank Holding Company Policy Statement (12 CFR part 225, appendix C), as well as top-tier savings and loan holding companies domiciled in the United States (together, banking organizations).<sup>3</sup> The proposed effective date for the provisions of this NPR is January 1, 2015, with an option for early adoption.

In a separate NPR (Basel III NPR), the agencies are proposing to revise their capital regulations to incorporate agreements reached by the Basel Committee on Banking Supervision (BCBS) in "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" (Basel III). The Basel III NPR would revise the definition of regulatory capital and minimum capital ratios, establish capital buffers, create a supplementary leverage ratio for advanced approach banking organizations, and revise the agencies' Prompt Corrective Action (PCA) regulations.

The agencies are proposing in a third NPR (Advanced Approaches and Market Risk NPR) to incorporate additional aspects of the Basel III framework into the advanced approaches risk-based capital rule (advanced approaches rule). Additionally, in the Advanced Approaches and Market Risk NPR, the Board proposes to apply the advanced approaches rule to savings and loan holding companies, and the Board, FDIC, and OCC propose to apply the market risk capital rule (market risk rule) to savings and loan holding companies and to state and federal

<sup>3</sup> Small bank holding companies would continue to be subject to the Small Bank Holding Company Policy Statement. The proposed rule's application to all savings and loan holding companies (including small savings and loan holding companies) is consistent with the transfer of supervisory responsibilities to the Board and the requirements of section 171 of the Dodd-Frank Act. Section 171 of the Dodd-Frank Act by its terms does not apply to small bank holding companies, but there is no exemption from the requirements of section 171 for small savings and loan holding companies. See 12 U.S.C. 5371.

savings associations that meet the scope requirements of these rules, respectively. Thus, the Advanced Approaches and Market Risk NPR is applicable only to banking organizations that are or would be subject to the advanced approaches rule (advanced approaches banking organizations) or the market risk rule, and to savings and loan holding companies and state and federal savings associations that would be subject to the advanced approaches rule or market risk rule.

All banking organizations, including organizations subject to the advanced approaches rule, should review both the Basel III NPR and the Standardized Approach NPR. The requirements proposed in the Basel III NPR and the Standardized Approach NPR are proposed to become the “generally applicable” capital requirements for purposes of section 171 of the Dodd-Frank Act because they would be the capital requirements for insured depository institutions under section 38 of the Federal Deposit Insurance Act, without regard to asset size or foreign financial exposure.<sup>4</sup>

The agencies believe that it is important to publish all of the proposed capital rules at the same time so that banking organizations can evaluate the overall potential impact of the proposals on their operations. The proposals are divided into three separate NPRs to reflect the distinct objectives of each proposal, to allow interested parties to better understand the various aspects of the overall capital framework, including which aspects of the proposals would apply to which banking organizations, and to help interested parties better focus their comments on areas of particular interest. Additionally, the agencies believe that separating the proposed requirements into three NPRs makes it easier for banking organizations of all sizes to more easily understand which proposed changes are related to the agencies’ objective to improve the quality and increase the quantity of capital and which are related to the agencies’ objective to enhance the overall risk-sensitivity of the calculation of a banking organization’s total risk-weighted assets. The agencies believe

that the proposed changes contained in the three NPRs will result in capital requirements that will improve institutions’ ability to withstand periods of economic stress and better reflect their risk profiles. The agencies have carefully considered the potential impact of the three NPRs on all banking organizations, including community banking organizations, and sought to minimize the potential burden of these changes wherever possible.

This NPR proposes new methodologies for determining risk-weighted assets in the agencies’ general capital rules, incorporating elements of the Basel II standardized approach<sup>5</sup> as modified by the 2009 “Enhancements to the Basel II Framework” (2009 Enhancements)<sup>6</sup> and recent consultative papers published by the BCBS. This NPR also proposes alternative standards of creditworthiness consistent with section 939A of the Dodd-Frank Act.<sup>7</sup> The proposed revisions in this NPR include revisions to recognition of credit risk mitigation, including a greater recognition of financial collateral and a wider range of eligible guarantors. They also include risk weighting of equity exposures and past due loans, operational requirements for securitization exposures, more favorable capital treatment for derivatives and repo-style transactions cleared through central counterparties, and disclosure requirements that would apply to top-tier banking organizations with \$50 billion or more in total assets that are not subject to the advanced approaches rule. In addition, the proposed risk weights for residential mortgage exposures in this NPR enhance risk-sensitivity for capital requirements associated with these exposures. Similarly, the proposals in this NPR would require a higher risk weighting for certain commercial real estate exposures that typically have higher credit risk. The agencies believe these proposals would more appropriately align capital requirements with these

exposures and contribute to the resilience of both individual banking organizations and the banking system.

Some of the proposed changes in this NPR are not specifically included in the Basel capital framework. However, the agencies believe that these proposed changes are generally consistent with the goals of that framework. For example, the Basel capital framework seeks to enhance the risk-sensitivity of the international risk-based capital requirements by mapping capital requirements for certain exposures to credit ratings provided by credit rating agencies. Instead of mapping risk weights to credit ratings, the agencies are proposing alternative standards of creditworthiness to assign risk weights to certain exposures, including exposures to sovereigns, companies, and securitization exposures, in a manner consistent with section 939A of the Dodd-Frank Act.<sup>8</sup> These alternative creditworthiness standards and risk-based capital requirements have been designed to be consistent with safety and soundness while also exhibiting risk-sensitivity to the extent possible. Furthermore, these capital requirements are intended to be similar to those generated under the Basel framework.

Table 1 summarizes key proposed requirements in this NPR and illustrates how these changes compare to the agencies’ general risk-based capital rules.<sup>9</sup> The remaining sections of this notice describe in detail each element of the proposal, how the proposal would differ from the current general risk-based capital rules, and examples for how a banking organization would calculate risk-weighted asset amounts.

<sup>8</sup> Section 939A of the Dodd-Frank Act provides that not later than 1 year after the date of enactment, each Federal agency shall review: (1) Any regulation issued by such agency that requires the use of an assessment of the credit-worthiness of a security or money market instrument; and (2) any references to or requirements in such regulations regarding credit ratings. Section 939A further provides that each such agency “shall modify any such regulations identified by the review \* \* \* to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations.” See 15 U.S.C. 78o–7 note.

<sup>9</sup> Banking organizations should refer to the Basel III NPR to see a complete table of the key provisions of the proposal.

<sup>4</sup> 12 U.S.C. 1831o; 12 CFR part 6, 12 CFR part 165 (OCC); 12 CFR 208.43 (Board), 12 CFR 325.105, 12 CFR 390.455 (FDIC).

<sup>5</sup> See BCBS, “International Convergence of Capital Measurement and Capital Standards: A Revised Framework,” (June 2006), available at <http://www.bis.org/publ/bcbs128.htm> (Basel II).

<sup>6</sup> See BCBS, “Enhancements to the Basel II Framework,” (July 2009), available at <http://www.bis.org/publ/bcbs157.htm>.

<sup>7</sup> Dodd-Frank Act, section 939A (15 U.S.C. 78o–7, note).

TABLE 1—KEY PROVISIONS OF THE PROPOSED REQUIREMENTS AS COMPARED TO THE GENERAL RISK-BASED CAPITAL RULES

Aspect of proposed requirements	Proposed treatment
<b>Risk-weighted Assets</b>	
Credit exposures to: U.S. government and its agencies ..... U.S. government-sponsored entities. U.S. depository institutions and credit unions. U.S. public sector entities, such as states and municipalities (section 32 of subpart D).	Unchanged.
Credit exposures to: Foreign sovereigns .....  Foreign banks ..... Foreign public sector entities (section 32 of subpart D)	Introduces a more risk-sensitive treatment using the Country Risk Classification measure produced by the Organization for Economic Co-operation and Development.
Corporate exposures (section 32 of subpart D)	Assigns a 100 percent risk weight to corporate exposures, including exposures to securities firms.
Residential mortgage exposures (section 32 of subpart D).	Introduces a more risk-sensitive treatment based on several criteria, including certain loan characteristics and the loan-to-value-ratio of the exposure.
High volatility commercial real estate exposures (section 32 of subpart D).	Applies a 150 percent risk weight to certain credit facilities that finance the acquisition, development or construction of real property.
Past due exposures (section 32 of subpart D) ...	Applies a 150 percent risk weight to exposures that are not sovereign exposures or residential mortgage exposures and that are more than 90 days past due or on nonaccrual.
Securitization exposures (sections 41–45 of subpart D).	Maintains the gross-up approach for securitization exposures.  Replaces the current ratings-based approach with a formula-based approach for determining a securitization exposure's risk weight based on the underlying assets and exposure's relative position in the securitization's structure.
Equity exposures (sections 51–53 of subpart D) Off-balance Sheet Items (section 33 of subpart D).	Introduces more risk-sensitive treatment for equity exposures. Revises the measure of the counterparty credit risk of repo-style transactions.
Derivative Contracts (section 34 of subpart D) ... Cleared Transactions (section 35 of subpart D)	Raises the credit conversion factor for most short-term commitments from zero percent to 20 percent. Removes the 50 percent risk weight cap for derivative contracts. Provides preferential capital requirements for cleared derivative and repo-style transactions (as compared to requirements for non-cleared transactions) with central counterparties that meet specified standards. Also requires that a clearing member of a central counterparty calculate a capital requirement for its default fund contributions to that central counterparty.
Credit Risk Mitigation (section 36 of subpart D) Disclosure Requirements (sections 61–63 of subpart D).	Provides a more comprehensive recognition of collateral and guarantees. Introduces qualitative and quantitative disclosure requirements, including regarding regulatory capital instruments, for banking organizations with total consolidated assets of \$50 billion or more that are not subject to the separate advanced approaches disclosure requirements.

This NPR proposes that, beginning on January 1, 2015, a banking organization would be required to calculate risk-weighted assets using the methodologies described herein. Until then, the banking organization may calculate risk-weighted assets using the methodologies in the current general risk-based capital rules.

Some of the proposed requirements in this NPR are not applicable to smaller, less complex banking organizations. To assist these banking organizations in rapidly identifying the elements of these proposals that would apply to them, this NPR and the Basel III NPR provide, as addenda to the corresponding preambles, a summary of the proposed changes in those NPRs as they would generally apply to smaller, less complex banking organizations. This NPR also contains a second addendum to the

preamble, which directs the reader to the definitions proposed under the Basel III NPR because they are applicable to the Standardized Approach NPR as well.

*Question 1:* The agencies seek comment on the advantages and disadvantages of the proposed standardized approach rule as it would apply to smaller and less complex banking organizations (community banking organizations). What specific changes, if any, to the rule would accomplish the agencies' goals of establishing improved risk-sensitivity and quality of capital in an appropriate manner? For example, in which areas might the proposed standardized approach for calculating risk-weighted assets include simpler approaches for community banking organizations or

longer transition periods? Provide specific suggestions.

*Question 2:* The agencies also seek comment on the advantages and disadvantages of allowing certain community banking organizations to continue to calculate their risk-weighted assets based on the methodology in the current general risk-based capital rules, as modified to meet the new Basel III requirements and any changes required under U.S. law, and as incorporated into a comprehensive regulatory framework.

For example, under this type of alternative approach, community banking organizations would be subject to the proposed new PCA thresholds, a capital conservation buffer, and other Basel III revisions to the capital framework including the definition of capital, as well as any changes related to section 939A of the Dodd-Frank Act.

As modified with these revisions, community banking organizations would continue using most of the same risk weights as under the current general risk-based capital rules, including for commercial and residential mortgage exposures.

Under this approach, banking organizations other than community banking organizations would use the proposed standardized approach risk weights to calculate the denominator of the risk-based capital ratio. The agencies request comment on the criteria they should consider when determining which banking organizations, if any, should be permitted to continue to calculate their risk-weighted assets using the methodology in the current general risk-based capital rules (revised as described above). Which banking organizations, consistent with section 171 of the Dodd-Frank Act, should be required to use the standardized approach?<sup>10</sup> What factors should the agencies consider in making this determination?

## II. Standardized Approach for Risk-weighted Assets

### A. Calculation of Standardized Total Risk-weighted Assets

Similar to the current general risk-based capital rules, under the proposal, a banking organization would calculate its total risk-weighted assets by adding together its on- and off-balance sheet risk-weighted asset amounts and making any relevant adjustments to incorporate required capital deductions.<sup>11</sup> Banking organizations subject to the market risk rule would be required to supplement their total risk-weighted assets as provided by the market risk rule.<sup>12</sup> Risk-weighted asset amounts generally would be determined by assigning on-balance sheet assets to broad risk-weight categories according to the counterparty, or, if relevant, the guarantor or collateral. Similarly, risk-weighted asset

<sup>10</sup> Section 171 of the Dodd-Frank Act provides that all banking organizations must be subject to minimum capital requirements that cannot be less than the “generally applicable risk-based capital rules” established by the appropriate federal banking agency to apply to insured depository institutions under section 38 of the Federal Deposit Insurance Act, regardless of total consolidated asset size or foreign financial exposure; which shall serve as a floor for any capital requirements the agency may require.

<sup>11</sup> See generally 12 CFR part 3, appendix A, section III; 12 CFR 167.6 (OCC); 12 CFR parts 208 and 225, appendix A, section III (Board); 12 CFR part 325, appendix A, sections I.I.C and I.I.D and 12 CFR 390.466 (FDIC).

<sup>12</sup> The proposed rules would incorporate the market risk rule into the integrated regulatory framework as subpart F. See the Advanced Approaches and Market Risk NPR for further discussion.

amounts for off-balance sheet items would be calculated using a two-step process: (1) Multiplying the amount of the off-balance sheet exposure by a credit conversion factor (CCF) to determine a credit equivalent amount, and (2) assigning the credit equivalent amount to a relevant risk-weight category.

A banking organization would determine its standardized total risk-weighted assets by calculating the sum of: (1) Its risk-weighted assets for general credit risk, cleared transactions, default fund contributions, unsettled transactions, securitization exposures, and equity exposures, each as defined below, *plus* (ii) market risk-weighted assets, if applicable, *less* (iii) the banking organization’s allowance for loan and lease losses (ALLL) that is not included in tier 2 capital (as described in section 20 of the proposal). The sections below describe in more detail how a banking organization would determine the risk-weighted asset amounts for its exposures.

### B. Risk-weighted Assets for General Credit Risk

Under this NPR, total risk-weighted assets for general credit risk is the sum of the risk-weighted asset amounts as calculated under section 31(a) of the proposal. As proposed, general credit risk exposures would include a banking organization’s on-balance sheet exposures, over-the-counter (OTC) derivative contracts, off-balance sheet commitments, trade and transaction-related contingencies, guaranties, repo-style transactions, financial standby letters of credit, forward agreements, or other similar transactions. General credit risk exposures would generally exclude unsettled transactions, cleared transactions, default fund contributions, securitization exposures, and equity exposures, each as the agencies propose to define. Section 32 describes the proposed risk weights that would apply to sovereign exposures; exposures to certain supranational entities and multilateral development banks (MDBs); exposures to government-sponsored entities (GSEs); exposures to depository institutions, foreign banks, and credit unions; exposures to public sector entities (PSEs); corporate exposures; residential mortgage exposures; pre-sold residential construction loans; statutory multifamily mortgages; high volatility commercial real estate (HVCRE) exposures; past due exposures; and other assets (including cash, gold bullion, certain mortgage servicing assets (MSAs) and deferred tax assets (DTAs)).

Generally, the exposure amount for the on-balance sheet component of an exposure is the banking organization’s carrying value for the exposure as determined under generally accepted accounting principles (GAAP). The exposure amount for an off-balance sheet component of an exposure is typically determined by multiplying the notional amount of the off-balance sheet component by the appropriate CCF as determined under section 33. The exposure amount for an OTC derivative contract or cleared transaction that is a derivative would be determined under section 34 while exposure amounts for collateralized OTC derivative contracts, collateralized cleared transactions that are derivatives, repo-style transactions, and eligible margin loans would be determined under section 37 of the proposal.

### 1. Exposures to Sovereigns

The agencies propose to retain the current rules’ risk weights for exposures to and claims directly and unconditionally guaranteed by the U. S. government or its agencies.<sup>13</sup> Accordingly, exposures to the U. S. government, its central bank, or a U.S. government agency and the portion of an exposure that is directly and unconditionally guaranteed by the U. S. government, the U.S. central bank, or a U.S. government agency would receive a zero percent risk weight.<sup>14</sup> Consistent with the current risk-based capital rules, the portion of a deposit insured by the FDIC or the National Credit Union Administration also may be assigned a zero percent risk weight. An exposure conditionally guaranteed by the U.S. government, its central bank, or a U.S. government agency would receive a 20 percent risk weight.<sup>15</sup>

<sup>13</sup> A U.S. government agency would be defined in the proposal as an instrumentality of the U.S. government whose obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. government.

<sup>14</sup> Similar to the current general risk-based capital rules, a claim would not be considered unconditionally guaranteed by a central government if the validity of the guarantee is dependent upon some affirmative action by the holder or a third party. See 12 CFR part 3, appendix A, section 1(c)(11) and 12 CFR 167.6 (OCC); 12 CFR parts 208 and 225, appendix A, section III.C.1 (Board); 12 CFR part 325, appendix A, section I.I.C. (footnote 35) and 12 CFR 390.466 (FDIC).

<sup>15</sup> Loss-sharing agreements entered into by the FDIC with acquirers of assets from failed institutions are considered conditional guarantees for risk-based capital purposes due to contractual conditions that acquirers must meet. The guaranteed portion of assets subject to a loss-sharing agreement may be assigned a 20 percent risk weight. Because the structural arrangements for these agreements vary depending on the specific terms of each agreement, institutions should consult with their primary federal supervisor to



The agencies' general risk-based capital rules generally assign risk weights to direct exposures to sovereigns and exposures directly guaranteed by sovereigns based on whether the sovereign is a member of the Organization for Economic Co-operation and Development (OECD) and, as applicable, whether the exposure is unconditionally or conditionally guaranteed by the sovereign.<sup>16</sup>

Under the proposal, a sovereign would be defined as a central government (including the U.S. government) or an agency, department, ministry, or central bank of a central government. The risk weight for a sovereign exposure would be determined using OECD Country Risk Classifications (CRCs) (the CRC methodology).<sup>17</sup> The OECD's CRCs are an assessment of a country's credit risk, used to set interest rate charges for transactions covered by the OECD arrangement on export credits.

The agencies believe that use of CRCs in the proposal is permissible under section 939A of the Dodd-Frank Act and that section 939A was not intended to apply to assessments of creditworthiness of organizations such as the OECD. Section 939A is part of Subtitle C of Title IX of the Dodd-Frank Act, which, among other things, enhances regulation by the U.S. Securities and Exchange Commission (SEC) of credit rating agencies, including Nationally Recognized Statistical Rating Organizations (NRSROs) registered with the SEC. Section 939, in Subtitle C of Title IX, removes references to credit ratings and NRSROs from federal statutes. In the introductory "findings" section to Subtitle C, which is entitled "Improvements to the Regulation of Credit Ratings Agencies," Congress characterized credit rating agencies as organizations that play a critical "gatekeeper" role in the debt markets and perform evaluative and analytical services on behalf of clients, and whose activities are fundamentally commercial in character.<sup>18</sup> Furthermore, the legislative history of section 939A

determine the appropriate risk-based capital treatment for specific loss-sharing agreements.

<sup>16</sup> 12 CFR part 3, appendix A, section 3 and 12 CFR 167.6 (OCC); 12 CFR parts 208 and 225, appendix A, section III.C.1 (Board); 12 CFR part 325, appendix A, section ILC and 12 CFR 390.466 (FDIC).

<sup>17</sup> For more information on the OECD country risk classification methodology, see OECD, "Country Risk Classification," available at [http://www.oecd.org/document/49/0,3746,en\\_2649\\_34169\\_1901105\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/49/0,3746,en_2649_34169_1901105_1_1_1_1,00.html).

<sup>18</sup> See Dodd-Frank Act, section 931 (15 U.S.C. 780-7 note).

focuses on the conflicts of interest of credit rating agencies in providing credit ratings to their clients, and the problem of government "sanctioning" of the credit rating agencies' credit ratings by having them incorporated into federal regulations. The OECD is not a commercial entity that produces credit assessments for fee-paying clients, nor does it provide the sort of evaluative and analytical services as credit rating agencies. Additionally, the agencies note that the use of the CRCs is limited in the proposal.

The CRC methodology, established in 1999, classifies countries into categories based on the application of two basic components: the country risk assessment model (CRAM), which is an econometric model that produces a quantitative assessment of country credit risk, and the qualitative assessment of the CRAM results, which integrates political risk and other risk factors not fully captured by the CRAM. The two components of the CRC methodology are combined and result in countries being classified into one of eight risk categories (0-7), with countries assigned to the zero category having the lowest possible risk assessment and countries assigned to the 7 category having the highest possible risk assessment.

The OECD regularly updates CRCs for more than 150 countries and makes the assessments publicly available on its Web site.<sup>19</sup> Accordingly, the agencies believe that the CRC approach should not represent undue burden to banking organizations. The use of the CRC methodology is consistent with the Basel II standardized approach, which, as an alternative to credit ratings, provides for risk weights to be assigned to sovereign exposures according to country risk scores provided by export credit agencies.

The agencies recognize that CRCs have certain limitations. Although the OECD has published a general description of the methodology for CRC determinations, the methodology is largely principles-based and does not provide details regarding the specific information and data considered to support a CRC. Additionally, while the OECD reviews qualitative factors for each sovereign on a monthly basis, quantitative financial and economic information used to assign CRCs is available only annually in some cases, and payment performance is updated quarterly. Also, OECD-member sovereigns that are defined to be "high-income countries" by the World Bank

<sup>19</sup> See [http://www.oecd.org/document/49/0,2340,en\\_2649\\_34171\\_1901105\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/49/0,2340,en_2649_34171_1901105_1_1_1_1,00.html).

are assigned a CRC of zero, the most favorable classification.<sup>20</sup> Despite these limitations, the agencies consider CRCs to be a reasonable alternative to credit ratings for sovereign exposures and the proposed CRC methodology to be more granular and risk-sensitive than the current risk-weighting methodology based on OECD membership.

The agencies also propose to require a banking organization to apply a 150 percent risk weight to sovereign exposures immediately upon determining that an event of sovereign default has occurred or if an event of sovereign default has occurred during the previous five years. Sovereign default would be defined as a noncompliance by a sovereign with its external debt service obligations or the inability or unwillingness of a sovereign government to service an existing loan according to its original terms, as evidenced by failure to pay principal and interest timely and fully, arrearages, or restructuring. A default would include a voluntary or involuntary restructuring that results in a sovereign not servicing an existing obligation in accordance with the obligation's original terms.

The agencies are proposing to map risk weights to CRCs in a manner consistent with the Basel II standardized approach, which provides risk weights for foreign sovereigns based on country risk scores. The proposed risk weights for sovereign exposures are set forth in table 2.

TABLE 2—PROPOSED RISK WEIGHTS FOR SOVEREIGN EXPOSURES

	Risk weight (in percent)
Sovereign CRC:	
0-1 .....	0
2 .....	20
3 .....	50
4-6 .....	100
7 .....	150
No CRC .....	100
Sovereign Default .....	150

If a banking supervisor in a sovereign jurisdiction allows banking organizations in that jurisdiction to apply a lower risk weight to an exposure to that sovereign than table 2 provides, a U.S. banking organization would be able to assign the lower risk weight to an exposure to that sovereign, provided

<sup>20</sup> OECD, "Premium and Related Conditions: Explanation of the Premium Rules of the Arrangement on Officially Supported Export Credits (the Knaepen Package)," (July 6, 2004), available at [http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=TD/P\(2004\)10/FINAL&docLanguage=En](http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=TD/P(2004)10/FINAL&docLanguage=En).

the exposure is denominated in the sovereign's currency and the U.S. banking organization has at least an equivalent amount of liabilities in that foreign currency.

*Question 3:* The agencies solicit comment on the proposed methodology for risk weighting sovereign exposures. Are there other alternative methodologies for risk weighting sovereign exposures that would be more appropriate? Provide specific examples and supporting data.

## 2. Exposures to Certain Supranational Entities and Multilateral Development Banks

Under the general risk-based capital rules, exposures to certain supranational entities and multilateral development banks (MDB) receive a 20 percent risk weight. Consistent with the Basel framework's treatment of exposures to supranational entities, the agencies propose to apply a zero percent risk weight to exposures to the Bank for International Settlements, the European Central Bank, the European Commission, and the International Monetary Fund.

Similarly, the agencies propose to apply a zero percent risk weight to exposures to an MDB in accordance with the Basel framework. The proposal would define an MDB to include the International Bank for Reconstruction and Development, the Multilateral Investment Guarantee Agency, the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the European Investment Fund, the Nordic Investment Bank, the Caribbean Development Bank, the Islamic Development Bank, the Council of Europe Development Bank, and any other multilateral lending institution or regional development bank in which the U.S. government is a shareholder or contributing member or which the primary federal supervisor determines poses comparable credit risk.

The agencies believe this treatment is appropriate in light of the generally high-credit quality of MDBs, their strong shareholder support, and a shareholder structure comprised of a significant proportion of sovereign entities with strong creditworthiness. Exposures to regional development banks and multilateral lending institutions that are not covered under the definition of MDB generally would be treated as corporate exposures.

## 3. Exposures to Government-Sponsored Entities

The agencies are proposing to assign a 20 percent risk weight to exposures to GSEs that are not equity exposures and a 100 percent risk weight to preferred stock issued by a GSE. While this is consistent with the current treatment under the FDIC and Board's rules, it would represent a change to the OCC's general risk-based capital rules for national banks, which currently allow a banking organization to apply a 20 percent risk weight to GSE preferred stock.<sup>21</sup>

Although the GSEs currently are in the conservatorship of the Federal Housing Finance Agency and receive capital support from the U.S. Treasury, they remain privately-owned corporations, and their obligations do not have the explicit guarantee of the full faith and credit of the United States. The agencies have long held the view that obligations of the GSEs should not be accorded the same treatment as obligations that carry the explicit guarantee of the U.S. government. Therefore, the agencies propose to continue to apply a 20 percent risk weight to debt exposures to GSEs.

## 4. Exposures to Depository Institutions, Foreign Banks, and Credit Unions

The general risk-based capital rules assign a 20 percent risk weight to all exposures to U.S. depository institutions and foreign banks incorporated in an OECD country. Short-term exposures to foreign banks incorporated in a non-OECD country receive a 20 percent risk weight and long-term exposures to such entities receive a 100 percent risk weight. The Basel II standardized approach allows for risk weights for a claim on a bank to be one risk weight category higher than the risk weight assigned to the sovereign exposures of a bank's home country. As described below, the agencies' propose treatment for depository institutions, foreign banks, and credit unions that is consistent with this approach.

Under the proposal, exposures to U.S. depository institutions and credit unions would be assigned a 20 percent risk weight.<sup>22</sup> For exposures to foreign

<sup>21</sup> 12 CFR part 3, appendix A section 3(a)(2)(vii), and 2 CFR part 167.6(a)(1)(ii)(F) (OCC); 12 CFR part 208, and 225, appendix A, section III.C.2.b (Board); 12 CFR part 325, appendix A, section II.C, and 12 CFR part 390.466(a)(1)(ii)(F) (FDIC). GSEs include the Federal Home Loan Mortgage Corporation (FHLMC), the Federal National Mortgage Association (FNMA), the Farm Credit System, and the Federal Home Loan Bank System.

<sup>22</sup> A depository institution is defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C.

banks, the proposal would include risk weights based on the CRC applicable to the entity's home country, in accordance with table 3.<sup>23</sup> Specifically, an exposure to a foreign bank would receive a risk weight one category higher than the risk weight assigned to a direct exposure to the entity's home country, as illustrated in table 3. Exposures to a foreign bank in a country that does not have a CRC would receive a 100 percent risk weight. A banking organization would be required to assign a 150 percent risk weight to an exposure to a foreign bank immediately upon determining that an event of sovereign default has occurred in the bank's home country, or if an event of sovereign default has occurred in the foreign bank's home country during the previous five years.

TABLE 3—PROPOSED RISK WEIGHTS FOR EXPOSURES TO FOREIGN BANKS

	Risk weight (in percent)
Sovereign CRC:	
0-1 .....	20
2 .....	50
3 .....	100
4-7 .....	150
No CRC .....	100
Sovereign Default .....	150

Exposures to a depository institution or foreign bank that are includable in the regulatory capital of that entity would receive a risk weight of 100 percent, unless the exposure is (i) An equity exposure, (ii) a significant investment in the capital of an unconsolidated financial institution in the form of common stock under section 22 of the proposal, (iii) an exposure that is deducted from regulatory capital under section 22 of the proposal, or (iv) an exposure that is subject to the 150 percent risk weight under section 32 of the proposal.

In 2011, the BCBS revised certain aspects of the Basel capital framework to address potential adverse effects of the framework on trade finance in low income countries.<sup>24</sup> In particular, the

1813(c)(1)). Under this proposal, a credit union refers to an insured credit union as defined under the Federal Credit Union Act (12 U.S.C. 1752(7)).

<sup>23</sup> Foreign bank means a foreign bank as defined in section 211.2 of the Federal Reserve Board's Regulation K (12 CFR 211.2), that is not a depository institution. For purposes of this proposal, home country means the country where an entity is incorporated, chartered, or similarly established.

<sup>24</sup> See BCBS, "Treatment of Trade Finance under the Basel Capital Framework," (October 2011), available at <http://www.bis.org/publ/bcb205.pdf>. "Low income country" is a designation used by the World Bank to classify economies (see World Bank,

framework was revised to remove the sovereign floor for trade finance-related claims on banking organizations under the Basel II standardized approach.<sup>25</sup> The proposed requirements would incorporate this revision and permit a banking organization to assign a 20 percent risk weight to self-liquidating, trade-related contingent items that arise from the movement of goods and that have a maturity of three months or less.

The Basel capital framework treats exposures to securities firms that meet certain requirements like exposures to depository institutions. However, the agencies do not believe that the risk profile of these firms is sufficiently similar to depository institutions to justify that treatment. Accordingly, the agencies propose to require banking organizations to treat exposures to securities firms as corporate exposures, which parallels the treatment of bank holding companies and savings and loan holding companies, as described in section II.B.6 of this preamble.

#### 5. Exposures to Public Sector Entities

The agencies' general risk-based capital rules assign a 20 percent risk weight to general obligations of states and other political subdivisions of OECD countries.<sup>26</sup> However, exposures that rely on repayment from specific projects (for example, revenue bonds) are assigned a risk weight of 50 percent. Other exposures to state and political

subdivisions of OECD countries (including industrial revenue bonds) and exposures to political subdivisions of non-OECD countries receive a risk weight of 100 percent. The risk weights assigned to revenue obligations are higher than the risk weight assigned to general obligations because repayment of revenue obligations depends on specific projects, which present more risk relative to a general repayment obligation of a state or political subdivision of a sovereign.

The agencies are proposing to apply the same risk weights to exposures to U.S. states and municipalities as the general risk-based capital rules apply. Under the proposal, these political subdivisions would be included in the definition of public sector entity PSE. Consistent with both the current rules and the Basel capital framework, the agencies propose to define a PSE as a state, local authority, or other governmental subdivision below the level of a sovereign. This definition would not include government-owned commercial companies that engage in activities involving trade, commerce, or profit that are generally conducted or performed in the private sector.

Under the proposal, a banking organization would assign a 20 percent risk weight to a general obligation exposure to a PSE that is organized under the laws of the United States or any state or political subdivision thereof

and a 50 percent risk weight to a revenue obligation exposure to such a PSE. A general obligation would be defined as a bond or similar obligation that is backed by the full faith and credit of a PSE. A revenue obligation would be defined as a bond or similar obligation that is an obligation of a PSE, but which the PSE is committed to repay with revenues from a specific project financed rather than general tax funds.

Similar to the Basel framework's use of home country risk weights to assign a risk weight to a PSE exposure, the agencies propose to require a banking organization to apply a risk weight to an exposure to a non-U.S. PSE based on (1) the CRC applicable to the PSE's home country and (2) whether the exposure is a general obligation or a revenue obligation, in accordance with table 4.

The risk weights assigned to revenue obligations would be higher than the risk weights assigned to a general obligation issued by the same PSE, as set forth in table 4. Similar to exposures to a foreign bank, exposures to a non-U.S. PSE in a country that does not have a CRC rating would receive a 100 percent risk weight. Exposures to a non-U.S. PSE in a country that has defaulted on any outstanding sovereign exposure or that has defaulted on any sovereign exposure during the previous five years would receive a 150 percent risk weight. Table 4 illustrates the proposed risk weights for exposures to non-U.S. PSEs.

TABLE 4—PROPOSED RISK WEIGHTS FOR EXPOSURES TO NON-U.S. PSE GENERAL OBLIGATIONS AND REVENUE OBLIGATIONS  
[In percent]

	Risk weight for exposures to non-U.S. PSE general obligations	Risk weight for exposures to non-U.S. PSE revenue obligations
Sovereign CRC:		
0-1 .....	20	50
2 .....	50	100
3 .....	100	100
4-7 .....	150	150
No CRC .....	100	100
Sovereign Default .....	150	150

In certain cases, under the general risk-based capital rules, the agencies have allowed a banking organization to rely on the risk weight that a foreign banking supervisor allows to assign to PSEs in that supervisor's country. Consistent with that approach, the

agencies propose to allow a banking organization to apply a risk weight to an exposure to a non-U.S. PSE according to the risk weight that the foreign banking organization supervisor allows to assign to it. In no event, however, may the risk weight for an exposure to a non-U.S.

PSE be lower than the risk weight assigned to direct exposures to that PSE's home country.

*Question 4:* The agencies request comment on the proposed treatment of exposures to PSEs.

<sup>25</sup> "How We Classify Countries," available at <http://data.worldbank.org/about/country-classifications>.

<sup>25</sup> The BCBS indicated that it removed the sovereign floor for such exposures to make access to trade finance instruments easier and less

expensive for low income countries. Absent removal of the floor, the risk weight assigned to these exposures, where the issuing banking organization is incorporated in a low income country, typically would be 100 percent.

<sup>26</sup> Political subdivisions of the United States would include a state, county, city, town or other municipal corporation, a public authority, and generally any publicly owned entity that is an instrument of a state or municipal corporation.

## 6. Corporate Exposures

Under the agencies' general risk-based capital rules, credit exposures to companies that are not depository institutions or securitization vehicles generally are assigned to the 100 percent risk weight category. A 20 percent risk weight is assigned to claims on, or guaranteed by, a securities firm incorporated in an OECD country, that satisfy certain conditions.

The proposed requirements would be generally consistent with the general risk-based capital rules and require banking organizations to assign a 100 percent risk weight to all corporate exposures. The proposal would define a corporate exposure as an exposure to a company that is not an exposure to a sovereign, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, an MDB, a depository institution, a foreign bank, or a credit union, a PSE, a GSE, a residential mortgage exposure, a pre-sold construction loan, a statutory multifamily mortgage, an HVCRE exposure, a cleared transaction, a default fund contribution, a securitization exposure, an equity exposure, or an unsettled transaction. In contrast to the agencies' general risk-based capital rules, securities firms would be subject to the same treatment as corporate exposures.

The agencies evaluated a number of alternatives to credit ratings to provide a more granular risk weight treatment for corporate exposures.<sup>27</sup> However, each of these alternatives was viewed as either having significant drawbacks, being too operationally complex, or as not being sufficiently developed to be proposed in this NPR.

## 7. Residential Mortgage Exposures

The general risk-based capital rules assign exposures secured by one-to-four family residential properties to either the 50 percent or the 100 percent risk-weight category. Exposures secured by a first lien on a one-to-four family residential property that meet certain prudential underwriting criteria and that are paying according to their terms generally receive a 50 percent risk weight.<sup>28</sup> The Basel II standardized approach similarly applies a broad treatment to residential mortgages, assigning a risk weight of 35 percent for

most first-lien residential mortgage exposures that meet certain prudential criteria, such as the existence of a substantial margin of additional security over the amount of the loan.

During the recent market turmoil, the U.S. housing market experienced significant deterioration and unprecedented levels of mortgage loan defaults and home foreclosures. The causes for the significant increase in loan defaults and home foreclosures included inadequate underwriting standards; the proliferation of high-risk mortgage products, such as so-called pay-option adjustable rate mortgages, which provide for negative amortization and significant payment shock to the borrower; the practice of issuing mortgage loans to borrowers with unverified or undocumented income; and a precipitous decline in housing prices coupled with a rise in unemployment. Given the characteristics of the U.S. residential mortgage market and this recent experience, the agencies believe that a wider range of risk weights based on key risk factors is more appropriate for the U.S. residential mortgage market. Therefore, the agencies are proposing a risk-weight framework that is different from both the general risk-based capital rules and the Basel capital framework.

### a. Categorization of Residential Mortgage Exposures; Loan-to-Value.

The proposed definition of a residential mortgage exposure would be an exposure that is primarily secured by a first or subsequent lien on one-to-four family residential property (and not a securitization exposure, equity exposure, statutory multifamily mortgage, or presold construction loan). The definition of residential mortgage exposure also would include an exposure that is primarily secured by a first or subsequent lien on residential property that is not one-to-four family if the original and outstanding amount of the exposure is \$1 million or less. A first-lien residential mortgage exposure would be a residential mortgage exposure secured by a first lien or by first and junior lien(s) where no other party holds an intervening lien. A junior-lien residential mortgage exposure would be a residential mortgage exposure that is not a first-lien residential mortgage exposure.

The NPR would maintain the current risk-based capital treatment for residential mortgage exposures that are guaranteed by the U.S. government or its agency. Accordingly, residential mortgage exposures that are unconditionally guaranteed by the U.S. government or a U.S. agency would

receive a zero percent risk weight, and residential mortgage exposures that are conditionally guaranteed by the U.S. government or a U.S. agency would receive a 20 percent risk weight.

Under the NPR, a banking organization would divide residential mortgage exposures that are not guaranteed by the U.S. government or one of its agencies into two categories. The agencies propose to apply relatively low risk weights for residential mortgage exposures that do not have product features associated with higher credit risk, and higher risk weights for nontraditional loans that present greater risk. As described further below, the risk weight assigned to a residential mortgage exposure will also depend on the loan's loan-to-value ratio.

The standards for category 1 residential mortgage exposures reflect those underwriting and product features that have demonstrated a lower risk of default both through supervisory experience and observations from the recent foreclosure crisis. Thus, the definition generally excludes mortgage products that include terms or other characteristics that the agencies have found to be indicative of higher risk. For example, the standards include consideration and documentation of a borrower's ability to repay, and would exclude certain higher risk product features, such as deferral of principal and balloon loans. Category 1 residential mortgages also would not include any junior lien mortgages. All residential mortgages that would not meet the definition of category 1 residential mortgage would be category 2 residential mortgages. See section 2 of the proposed rules for the definitions of "category 1 residential mortgage" in the related notice titled "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action."

The agencies believe that the proposed divergence in risk weights for category 1 and category 2 residential mortgage exposures appropriately reflects differences in risk between mortgages in the two categories. Because category 2 residential mortgage exposures generally are of higher risk than category 1 residential mortgage exposures, the minimum proposed risk weight for a category 2 residential mortgage exposure is 100 percent.

Under the general risk-based capital rules, a banking organization must assign a minimum 100 percent risk weight to an exposure secured by a junior lien on residential property, unless the banking organization also

<sup>27</sup> See, for example, 76 FR 73526 (Nov. 29, 2011) and 76 FR 73777 (Nov. 29, 2011).

<sup>28</sup> See 12 CFR part 3, appendix A, section 3(c)(iii) and 12 CFR part 167.6(a)(1)(iii) (OCC); 12 CFR parts 208 and 225, appendix A, section III.C.3 (Board); 12 CFR part 325, appendix A, section II.C.3 and 12 CFR 390.461 (definition of "qualifying mortgage loan") (FDIC).

holds the first lien and there are no intervening liens. The agencies also propose to require a banking organization that holds both a first and junior lien on the same property to combine the exposures into one first-lien residential mortgage exposure for purposes of determining the loan-to-value (LTV) and risk weight for the combined exposure. However, a banking organization could only categorize the combined exposure as a category 1 residential mortgage exposure if the terms and characteristics of both mortgages meet all of the criteria for category 1 residential mortgage exposures. This requirement would ensure that no residential mortgage products associated with higher risk may be categorized as category 1 residential mortgage exposures.

Except as described in the preceding paragraph, under this NPR, a banking organization would classify all junior-lien residential mortgage exposures as category 2 residential mortgage exposures in light of the increased risk associated with junior liens demonstrated in the recent foreclosure crisis.

The proposed risk weighting would depend on not only the mortgage exposure's status as a category 1 or category 2 residential mortgage exposure, but also on the mortgage exposure's LTV ratio. The amount of equity a borrower has in a residential property is highly correlated with default risk, and the agencies believe that it is appropriate that LTV be an important component in assigning risk weights to residential mortgage exposures. However, the agencies stress that the use of LTV ratios to assign risk weights to residential mortgage exposures is not a substitute for, and does not otherwise release a banking organization from, its responsibility to have prudent loan underwriting and risk management practices consistent with the size, type, and risk of its mortgage business.<sup>29</sup>

The agencies are proposing in this NPR to require a banking organization to calculate the LTV ratios of a residential mortgage exposure as follows. The denominator of the LTV ratio, that is, the value of the property, would be

equal to the lesser of the actual acquisition cost for the property (for a purchase transaction) or the estimate of a property's value at the origination of the loan or at the time of restructuring or modification. The estimate of value would be based on an appraisal or evaluation of the property in conformance with the agencies' appraisal regulations<sup>30</sup> and should conform to the "Interagency Appraisal and Evaluation Guideline" and the "Real Estate Lending Guidelines."<sup>31</sup> If a banking organization's first-lien residential mortgage exposure consists of both first and junior liens on a property, a banking organization would update the estimate of value at the origination of the junior-lien mortgage.

The loan amount for a first-lien residential mortgage exposure is the unpaid principal balance of the loan unless the first-lien residential mortgage exposure was a combination of a first and junior lien. In that case, the loan amount would be the sum of the unpaid principal balance of the first lien and the maximum contractual principal amount of the junior lien. The loan amount of a junior-lien residential mortgage exposure is the maximum contractual principal amount of the exposure, plus the maximum contractual principal amounts of all senior exposures secured by the same residential property on the date of origination of the junior-lien residential mortgage exposure.

As proposed, a banking organization would not calculate a separate risk-weighted asset amount for the funded and unfunded portions of a residential mortgage exposure. Instead, the proposal would require only the calculation of a single LTV ratio representing a combined funded and unfunded amount when calculating the LTV ratio. Thus, the loan amount of a first-lien residential mortgage exposure would equal the funded principal amount (or combined exposures provided there is no intervening lien) plus the exposure amount of any unfunded commitment (that is, the unfunded amount of the maximum contractual amount of any commitment multiplied by the appropriate CCF). The loan amount of a junior-lien residential mortgage exposure would equal the sum of: (1) The funded principal amount of the exposure, (2) the exposure amount of any undrawn commitment associated

with the junior-lien exposure, and (3) the exposure amount of any senior exposure held by a third party on the date of origination of the junior-lien exposure. If a senior exposure held by a third party includes an undrawn commitment, such as a HELOC or a negative amortization feature, the loan amount for a junior-lien residential mortgage exposure would include the maximum contractual amount of that commitment.

The agencies believe that the LTV information should be readily available from the mortgage loan documents and thus should not present an issue for banking organizations in calculating the risk-based capital under the proposed requirements.

A banking organization would not be able to recognize private mortgage insurance (PMI) when calculating the LTV ratio of a residential mortgage exposure. The agencies believe that, due to the varying degree of financial strength of mortgage providers, it would not be prudent to recognize PMI for purposes of the general risk-based capital rules.

*Question 5:* The agencies solicit comments on all aspects of this NPR for determining the risk weights of residential mortgage loans, including the use of the LTV ratio to determine the risk-based capital treatment. What alternative criteria or approaches to categorizing mortgage loans would enable the agencies to appropriately and consistently differentiate among the levels of risk inherent in different mortgage exposures? For example, should all residential mortgages that meet the "qualified mortgage" criteria to be established for the purposes of the Truth in Lending Act pursuant to section 1412 of the Dodd-Frank Act be included in category 1? For category 1 residential mortgage exposures with interest rates that adjust or reset, would a proposed limit based directly on the amount the mortgage payment increases rather than on a change in interest rate be more appropriate? Why or why not? Does this proposal appropriately address loans with balloon payments and the risk of reverse mortgage loans? Why or why not? Provide detailed explanations and supporting data wherever possible.

*Question 6:* The agencies solicit comment on whether to allow banking organizations to recognize mortgage insurance for purposes of calculating the LTV ratio of a residential mortgage exposure under the standardized approach. What criteria could the agencies use to ensure that only financially sound PMI providers are recognized?

<sup>29</sup> See, for example, "Interagency Guidance on Nontraditional Mortgage Product Risks," 71 FR 58609 (Oct. 4, 2006) and "Statement on Subprime Mortgage Lending," 72 FR 37569 (July 10, 2007). In addition, there is ongoing implementation of certain aspects of the mortgage reform initiatives under various sections of the Dodd-Frank Act. For example, section 1141 of the Dodd-Frank Act amended the Truth in Lending Act to prohibit creditors from making mortgage loans without regard to a consumer's repayment ability. See 15 U.S.C. 1639c.

<sup>30</sup> 12 CFR part 34, subpart C (OCC); 12 CFR part 208, subpart E and 12 CFR part 225, subpart G (Board); 12 CFR part 323 and 12 CFR part 390, subpart X (FDIC).

<sup>31</sup> 12 CFR part 34, subpart D and 12 CFR part 160 (OCC); 12 CFR part 208, subpart E (Board); 12 CFR part 323 and 12 CFR 390.442 (FDIC).

b. Risk Weights for Residential Mortgage Exposures

As proposed, a banking organization would determine the risk weight for a

residential mortgage exposure using table 5 based on the loan's LTV ratio and whether it is a category 1 or

category 2 residential mortgage exposure.

TABLE 5—PROPOSED RISK WEIGHTS FOR RESIDENTIAL MORTGAGE EXPOSURES

Loan-to-value ratio (in percent)	Category 1 residential mortgage exposure (in percent)	Category 2 residential mortgage exposure (in 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

As an example risk weight calculation, a category 1 residential mortgage loan that has a loan amount of \$100,000 and a property value of \$125,000 at origination would result in an LTV of 80 percent and would be assigned a risk weight of 50 percent. If, at the time of restructuring the loan at a later date, the loan amount is \$92,000 and the value of the property is determined to be \$110,000, the LTV would be 84 percent and the applicable risk weight would be 75 percent.

c. Modified or Restructured Residential Mortgage Exposures

Under the current general risk-based capital rules, a residential mortgage may be assigned to the 50 percent risk weight category only if it is performing in accordance with its original terms or not restructured. The recent crises and ongoing problems in the housing market have demonstrated the profound negative effect foreclosures have on homeowners and their communities. Where practicable, modification or restructuring of a residential mortgage can be an effective means for a borrower to avoid default and foreclosure and for a banking organization to reduce risk of loss.

The agencies have recognized the importance of the prudent use of mortgage restructuring and modification in a banking organization's risk management and believe that restructuring or modification can reduce the risk of a residential mortgage exposure. Therefore, in this NPR, the agencies are not proposing to automatically raise the risk weight for a residential mortgage exposure if it is restructured or modified. Instead, under this NPR, a banking organization would categorize a modified or restructured residential mortgage exposure as a category 1 or category 2 residential mortgage exposure in accordance with the terms and characteristics of the

exposure after the modification or restructuring.

Additionally, to ensure that the banking organization applies a risk weight to a restructured or modified mortgage that most accurately reflects its risk profile, a banking organization could only apply (1) a risk weight lower than 100 percent to a category 1 residential mortgage exposure or (2) a risk weight lower than 200 percent to a category 2 residential mortgage exposure if the banking organization updated the LTV ratio of the exposure at the time of the modification or restructuring.

In further recognition of the importance of residential mortgage modifications and restructuring, a residential mortgage exposure modified or restructured on a permanent or trial basis solely pursuant to the U.S. Treasury's Home Affordable Mortgage Program (HAMP) would not be restructured or modified under the proposed requirements and would receive the risk weight provided in table 5.

The agencies believe that treating mortgage loans modified pursuant to HAMP in this manner is appropriate in light of the special and unique incentive features of HAMP, and the fact that the program is offered by the U.S. government to achieve the public policy objective of promoting sustainable loan modifications for homeowners at risk of foreclosure in a way that balances the interests of borrowers, servicers, and lenders. The program includes specific debt-to-income ratio requirements, which should better ensure the borrower's ability to repay the modified loan, and it provides for the U.S. Treasury Department to match reductions in monthly payments dollar-for-dollar to reduce the borrower's front-end debt-to-income ratio.

Additionally, the program provides financial incentives for servicers and lenders to take actions to reduce the

likelihood of defaults, as well as for servicers and borrowers designed to help borrowers remain current on modified loans. The structure and amount of these cash payments align the financial incentives of servicers, lenders, and borrowers to encourage and increase the likelihood of participating borrowers remaining current on their mortgages. Each of these incentives is important to the agencies' determination with respect to the appropriate regulatory capital treatment of mortgage loans modified under HAMP.

*Question 7:* The agencies request comment on whether loan modifications made pursuant to federal or state housing programs warrant specific provisions in the agencies' risk-based capital regulations at all, and if they do what criteria should be considered when determining the appropriate risk-based capital treatment for modified residential mortgages, given the risk characteristics of loans that require modification.

8. Pre-sold Construction Loans and Statutory Multifamily Mortgages

The general risk-based capital rules assign either a 50 percent or a 100 percent risk weight to certain one-to-four family residential pre-sold construction loans and to multifamily residential loans, consistent with the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 (RTCRI Act).<sup>32</sup> This NPR would maintain this general treatment while clarifying and

<sup>32</sup> The RTCRI Act mandates that each agency provide in its capital regulations (i) a 50 percent risk weight for certain one-to-four-family residential pre-sold construction loans and multifamily residential loans that meet specific statutory criteria in the RTCRI Act and any other underwriting criteria imposed by the agencies, and (ii) a 100 percent risk weight for one-to-four-family residential pre-sold construction loans for residences for which the purchase contract is cancelled. 12 U.S.C. 1831n, note.

updating the way the general risk-based capital rules define these exposures.

Under this NPR, a pre-sold construction loan would be subject to a 50 percent risk weight unless the purchase contract is cancelled. This NPR would define a pre-sold construction loan as any one-to-four family residential construction loan to a builder that meets the requirements of section 618(a)(1) or (2) of the RTCRRI Act and the agencies' existing regulations. A multifamily mortgage that does not meet the proposed definition of a statutory multifamily mortgage would be treated as a corporate exposure. The proposed definitions are in section 2 of the proposed rules in the related notice titled "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action."

#### 9. High Volatility Commercial Real Estate Exposures

In this NPR, the agencies are including a new risk-based capital treatment for certain commercial real estate exposures that currently receive a 100 percent risk weight under the general risk-based capital rules. Supervisory experience has demonstrated that certain acquisition, development, and construction (ADC) loans exposures present unique risks for which the agencies believe banking organizations should hold additional capital. Accordingly, the agencies propose to require banking organizations to assign a 150 percent risk weight to any High Volatility Commercial Real Estate Exposure (HVCRE). The proposal would define an HVCRE exposure to include any 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 mortgage property, or commercial real estate projects that meet certain prudential criteria, including with respect to the LTV ratio and capital contributions or expense contributions of the borrower. See the definition of "high volatility commercial real estate exposure" in section 2 of the proposed rules in the related notice entitled "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action".

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

*Question 8:* The agencies solicit comment on the proposed treatment for HVCRE exposures.

#### 10. Past Due Exposures

Under the general risk-based capital rules, the risk weight of a loan does not change if the loan becomes past due, with the exception of certain residential mortgage loans. The Basel II standardized approach provides risk weights ranging from 50 to 150 percent for loans that are more than 90 days past due to reflect the increased risk of loss. The agencies believe that a higher risk is appropriate for past due exposures to reflect the increased risk associated with such exposures.

Accordingly, consistent with the Basel capital framework and to reflect impaired credit quality of such exposures, the agencies propose that a banking organization assign a risk weight of 150 percent to an exposure that is not guaranteed or not secured (and that is not a sovereign exposure or a residential mortgage exposure) if it is 90 days or more past due or on nonaccrual. A banking organization may assign a risk weight to the collateralized or guaranteed portion of the past due exposure if the collateral, guarantee, or credit derivative meets the proposed requirements for recognition described in sections 36 and 37.

*Question 9:* The agencies solicit comments on the proposed treatment of past due exposures.

#### 11. Other Assets

In this NPR, the agencies propose to apply the following risk weights for exposures not otherwise assigned to a specific risk weight category, which are generally consistent with the risk weights in the general risk-based capital rules:

(1) A zero percent risk weight to cash owned and held in all of a banking organization's offices or in transit; gold bullion held in the banking organization's own vaults, or held in another depository institution's vaults on an allocated basis to the extent gold bullion assets are offset by gold bullion liabilities; and to exposures that arise from the settlement of cash transactions (such as equities, fixed income, spot foreign exchange and spot commodities) with a central counterparty where there is no assumption of ongoing counterparty credit risk by the central counterparty after settlement of the trade and associated default fund contributions;

(2) A 20 percent risk weight to cash items in the process of collection; and

(3) A 100 percent risk weight to all assets not specifically assigned a

different risk weight under this NPR (other than exposures that would be deducted from tier 1 or tier 2 capital).

In addition, subject to proposed transition arrangements, a banking organization would assign:

(1) A 100 percent risk weight to DTAs arising from temporary differences that the banking organization could realize through net operating loss carrybacks; and

(2) A 250 percent risk weight to MSAs and DTAs arising from temporary differences that the banking organization could not realize through net operating loss carrybacks that are not deducted from common equity tier 1 capital pursuant to section 22(d) of the proposal.

The proposed requirements would provide limited flexibility to address situations where exposures of a depository institution holding company or nonbank financial company supervised by the Board, that are not exposures typically held by depository institutions, do not fit wholly within the terms of another risk-weight category. Under the proposal, such exposures could be assigned to the risk weight category applicable under the capital rules for bank holding companies, provided that (1) the depository institution holding company or nonbank financial company is not authorized to hold the asset under applicable law other than debt previously contracted or similar authority; and (2) the risks associated with the asset are substantially similar to the risks of assets that are otherwise assigned to a risk weight category of less than 100 percent under subpart D of the proposal.

#### C. Off-balance Sheet Items

Under this NPR, as under the general risk-based capital rules, a banking organization would calculate the exposure amount of an off-balance sheet item by multiplying the off-balance sheet component, which is usually the notional amount, by the applicable credit conversion factor (CCF). This treatment would be applied to off-balance sheet items, such as commitments, contingent items, guarantees, certain repo-style transactions, financial standby letters of credit, and forward agreements.

Also similar to the general risk-based capital rules, a banking organization would apply a zero percent CCF to the unused portion of commitments that are unconditionally cancelable by the banking organization. For purposes of this NPR, a commitment would mean any legally binding arrangement that obligates a banking organization to extend credit or to purchase assets.



Unconditionally cancelable would mean a commitment that a banking organization may, at any time, with or without cause, refuse to extend credit under the commitment (to the extent permitted under applicable law). In the case of a residential mortgage exposure that is a line of credit, a banking organization would be deemed able to unconditionally cancel the commitment if it can, at its option, prohibit additional extensions of credit, reduce the credit line, and terminate the commitment to the full extent permitted by applicable law. If a banking organization provides a commitment that is structured as a syndication, it would only be required to calculate the exposure amount for its pro rata share of the commitment.

The agencies propose to increase a CCF from zero percent to 20 percent for commitments with an original maturity of one year or less that are not unconditionally cancelable by a banking organization, as consistent with the Basel II standardized approach. The proposed requirements would maintain the 20 percent CCF for self-liquidating, trade-related contingent items that arise from the movement of goods with an original maturity of one year or less.

As under the general risk-based capital rules, a banking organization would apply a 50 percent CCF to commitments with an original maturity of more than one year that are not unconditionally cancelable by the banking organization; and to transaction-related contingent items, including performance bonds, bid bonds, warranties, and performance standby letters of credit.

Under this NPR, a banking organization would be required to apply a 100 percent CCF to off-balance sheet guarantees, repurchase agreements, securities lending or borrowing transactions, financial standby letters of credit; forward agreements, and other similar exposures. The off-balance sheet component of a repurchase agreement would equal the sum of the current market values of all positions the banking organization has sold subject to repurchase. The off-balance sheet component of a securities lending transaction would be the sum of the current market values of all positions the banking organization has lent under the transaction. For securities borrowing transactions, the off-balance sheet component would be the sum of the current market values of all non-cash positions the banking organization has posted as collateral under the transaction. In certain circumstances, a banking organization may instead determine the exposure amount of the

transaction as described in section II.F.2 of this preamble and section 37 of the proposal.

The calculation of the off-balance sheet component for repurchase agreements, and securities lending and borrowing transactions described above represents a change to the general risk-based capital treatment for such transactions. Under the general risk-based capital rules, capital is required for any on-balance sheet exposure that arises from a repo-style transaction (that is, a repurchase agreement, reverse repurchase agreement, securities lending transaction, and securities borrowing transaction). For example, capital is required against the cash receivable that a banking organization generates when it borrows a security and posts cash collateral to obtain the security. However, a banking organization faces counterparty credit risk on a repo-style transaction, regardless of whether the transaction generates an on-balance sheet exposure. Therefore, in contrast to the general risk-based capital rules, this NPR would require a banking organization to hold risk-based capital against all repo-style transactions, regardless of whether they generate on-balance sheet exposures, as described in section 37 of the proposal.

Under the general risk-based capital rules, a banking organization is subject to a risk-based capital requirement when it provides credit-enhancing representations and warranties on assets sold or otherwise transferred to third parties as such positions are considered recourse arrangements.<sup>33</sup> However, the general risk-based capital rules do not impose a risk-based capital requirement on assets sold or transferred with representations and warranties that contain (1) Certain early default clauses, (2) certain premium refund clauses that cover assets guaranteed, in whole or in part, by the U.S. government, a U.S. government agency, or a U.S. GSE; or (3) warranties that permit the return of assets in instances of fraud, misrepresentation, or incomplete documentation.<sup>34</sup>

Under this NPR, if a banking organization provides a credit-enhancing representation or warranty on assets it sold or otherwise transferred to third parties, including in cases of

early default clauses or premium-refund clauses, the banking organization would treat such an arrangement as an off-balance sheet guarantee and apply a 100 percent credit conversion factor (CCF) to the exposure amount. The agencies are proposing a different treatment than the one under the general risk-based capital rules because the agencies believe that a banking organization should hold capital for such exposures while credit-enhancing representations and warranties are in place.

*Question 10:* The agencies solicit comment on the proposed treatment of credit-enhancing representations and warranties.

The proposed risk-based capital treatment for off-balance sheet items is consistent with section 165(k) of the Dodd-Frank Act which provides that, in the case of a bank holding company with \$50 billion or more in total consolidated assets the computation of capital for purposes of meeting capital requirements shall take into account any off-balance-sheet activities of the company.<sup>35</sup> The proposal complies with the requirements of section 165(k) of the Dodd-Frank Act by requiring a bank holding company to hold risk-based capital for its off-balance sheet exposures, as described in sections 31, 33, 34 and 35 of the proposal.

#### *D. Over-the-counter Derivative Contracts*

In this NPR, the agencies propose generally to retain the treatment of over-the-counter (OTC) derivatives provided under the general risk-based capital rules, which is similar to the current exposure method for determining the exposure amount for OTC derivative contracts contained in the Basel II standardized approach.<sup>36</sup> The proposed

<sup>35</sup> Section 165(k) of the Dodd-Frank Act (12 U.S.C. 5365(k)). This section defines an off-balance sheet activity as an existing liability of a company that is not currently a balance sheet liability, but may become one upon the happening of some future event. Such transactions may include direct credit substitutes in which a banking organization substitutes its own credit for a third party; irrevocable letters of credit; risk participations in bankers' acceptances; sale and repurchase agreements; asset sales with recourse against the seller; interest rate swaps; credit swaps; commodities contracts; forward contracts; securities contracts; and such other activities or transactions as the Board may define through a rulemaking.

<sup>36</sup> The general risk-based capital rules for savings associations regarding the calculation of credit equivalent amounts for derivative contracts differ from the rules for other banking organizations. (See 12 CFR 167(a)(2) (federal savings associations) and 12 CFR 390.466(a)(2) (state savings associations)). The savings association rules address only interest rate and foreign exchange rate contracts and include certain other differences. Accordingly, the description of the general risk-based capital rules in this preamble primarily reflects the rules applicable

<sup>33</sup> 12 CFR 3, appendix A, section 4(a)(11) and 12 CFR 167.6(b) (OCC); 12 CFR parts 208 and 225 appendix A, section III.B.3.a.xii (Board); 12 CFR part 325, appendix A, section II.B.5(a) and 12 CFR 390.466(b) (FDIC).

<sup>34</sup> 12 CFR part 3, appendix A, section 4(a)(8) and 12 CFR 167.6(b) (OCC); 12 CFR part 208, appendix A, section II.B.3.a.ii.1 and 12 CFR part 225, appendix A, section III.B.3.a.ii.(1) (Board); and 12 CFR part 325, appendix A, section II.B.5(a) and 12 CFR part 390.466(b) (FDIC).



revisions to the treatment of the OTC derivative contracts include an updated definition of an OTC derivative contract, a revised conversion factor matrix for calculating the potential future exposure (PFE), a revision of the criteria for recognizing the netting benefits of qualifying master netting agreements and of financial collateral, and the removal of the 50 percent risk weight limit for OTC derivative contracts.

Under the proposed requirements, as under the general risk-based capital rules, a banking organization would be required to hold risk-based capital for counterparty credit risk for OTC derivative contracts. As defined in this NPR, a derivative contract is a financial contract whose value is derived from the values of one or more underlying assets, reference rates, or indices of asset values or reference rates. A derivative contract would include an interest rate, exchange rate, equity, or a commodity derivative contract, a credit derivative, and any other instrument that poses similar counterparty credit risks. Under the proposal, derivative contracts also would include unsettled securities, commodities, and foreign exchange

transactions with a contractual settlement or delivery lag that is longer than the lesser of the market standard for the particular instrument or five business days. This applies, for example, to mortgage-backed securities transactions that the GSEs conduct in the To-Be-Announced market.

An OTC derivative contract would not include a derivative contract that is a cleared transaction, which would be subject to a specific treatment as described in section II.E of this preamble. OTC derivative contracts would, however, include an exposure of a banking organization that is a clearing member to its clearing member client where the banking organization is either acting as a financial intermediary and enters into an offsetting transaction with a central counterparty (CCP) or where the banking organization provides a guarantee to the CCP on the performance of the client. These transactions may not be treated as cleared transactions because the banking organization remains exposed directly to the risk of the individual counterparty.

To determine the risk-weighted asset amount for an OTC derivative contract under the proposal, a banking organization would first determine its exposure amount for the contract and then apply to that amount a risk weight based on the counterparty, eligible guarantor, or recognized collateral.

For a single OTC derivative contract that is not subject to a qualifying master netting agreement (as defined further below in this section), the exposure amount would be the sum of (1) the banking organization's current credit exposure, which would be the greater of the mark-to-market value or zero, and (2) PFE, which would be calculated by multiplying the notional principal amount of the OTC derivative contract by the appropriate conversion factor, in accordance with table 6 below.

Under this NPR, the conversion factor matrix would be revised to include the additional categories of OTC derivative contracts as illustrated in table 6. For an OTC derivative contract that does not fall within one of the specified categories in table 6, the PFE would be calculated using the appropriate "other" conversion factor.

TABLE 6—CONVERSION FACTOR MATRIX FOR OTC DERIVATIVE CONTRACTS<sup>37</sup>

Remaining maturity <sup>38</sup>	Interest rate	Foreign exchange rate and gold	Credit (investment-grade reference asset) <sup>39</sup>	Credit (non-investment-grade reference asset)	Equity	Precious metals (except gold)	Other
One year or less .....	0.00	0.01	0.05	0.10	0.06	0.07	0.10
Greater than one year and less than or equal to five years .....	0.005	0.05	0.05	0.10	0.08	0.07	0.12
Greater than five years .....	0.015	0.075	0.05	0.10	0.10	0.08	0.15

For multiple OTC derivative contracts subject to a qualifying master netting agreement, the exposure amount would be calculated by adding the net current credit exposure and the adjusted sum of the PFE amounts for all OTC derivative contracts subject to the qualifying master netting agreement. The net current credit exposure would be the greater of zero and the net sum of all positive and negative mark-to-market values of the individual OTC derivative contracts subject to the qualifying master netting agreement. The adjusted

sum of the PFE amounts would be calculated as described in section 34(a)(2)(ii) of the proposal.

Under the general risk-based capital rules, a banking organization must enter into a bilateral master netting agreement with its counterparty and obtain a written and well-reasoned legal opinion of the enforceability of the netting agreement for each of its netting agreements that cover OTC derivative contracts to recognize the netting benefit. Similarly, under this NPR, to recognize netting of multiple OTC

derivative contracts, the contracts would be required to be subject to a qualifying master netting agreement; however, for most transactions, a banking organization may rely on sufficient legal review instead of an opinion on the enforceability of the netting agreement as described below. Under this NPR, a qualifying master netting agreement would be defined as any written, legally enforceable netting agreement, that creates a single legal obligation for all individual transactions covered by the agreement upon an event

to state and national banks and bank holding companies.

<sup>37</sup> For a derivative contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the derivative contract.

<sup>38</sup> For a derivative contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the contract is zero, the remaining maturity equals the time until the next reset date. For an interest rate derivative contract with a remaining maturity of greater than one year that meets these criteria, the minimum conversion factor is 0.005.

<sup>39</sup> A banking organization would use the column labeled "Credit (investment-grade reference asset)" for a credit derivative whose reference asset is an outstanding unsecured long-term debt security without credit enhancement that is investment grade. A banking organization would use the column labeled "Credit (non-investment-grade reference asset)" for all other credit derivatives.

of default (including receivership, insolvency, liquidation, or similar proceeding) provided that certain conditions are met. These conditions include requirements with respect to the banking organization's right to terminate the contract and lien date collateral and meeting certain standards with respect to legal review of the agreement to ensure it meets the criteria in the definition.

The legal review must be sufficient so that the banking organization may conclude with a well-founded basis that, among other things the contract would be found legal, binding, and enforceable under the law of the relevant jurisdiction and that the contract meets the other requirements of the definition. In some cases, the legal review requirement could be met by reasoned reliance on a commissioned legal opinion or an in-house counsel analysis. In other cases, for example, those involving certain new derivative transactions or derivative counterparties in jurisdictions where a banking organization has little experience, the banking organization would be expected to obtain an explicit, written legal opinion from external or internal legal counsel addressing the particular situation. See the definition of "qualifying master netting agreement" in section 2 of the proposed rules in the related notice titled "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action."

If an OTC derivative contract is collateralized by financial collateral, a banking organization would first determine the exposure amount of the OTC derivative contract as described in this section. Next, to recognize the credit risk mitigation benefits of the financial collateral, a banking organization could use the simple approach for collateralized transactions as described in section 37(b) of the proposal. Alternatively, if the financial collateral is marked-to-market on a daily basis and subject to a daily margin maintenance requirement, a banking organization could adjust the exposure amount of the contract using the collateral haircut approach described in section 37(c) of the proposal.

Under this NPR, a banking organization would be required to treat an equity derivative contract as an equity exposure and compute its risk-weighted asset amount according to the proposed calculation requirements described in section 52 (unless the contract is a covered position under subpart F of the proposal). If the

banking organization risk weights a contract under the Simple Risk-Weight Approach described in section 52, it may choose not to hold risk-based capital against the counterparty risk of the equity contract, so long as it does so for all such contracts. Where the OTC equity contracts are subject to a qualified master netting agreement, a banking organization would either include or exclude all of the contracts from any measure used to determine counterparty credit risk exposures. If the banking organization is treating an OTC equity derivative contract as a covered position under subpart F, it would calculate a risk-based capital requirement for counterparty credit risk of the contract under section 34.

Similarly, if a banking organization purchases a credit derivative that is recognized under section 36 of the proposal as a credit risk mitigant for an exposure that is not a covered position under subpart F of the proposal, it would not be required to compute a separate counterparty credit risk capital requirement for the credit derivative, provided it does so consistently for all such credit derivative contracts. Further, where these credit derivative contracts are subject to a qualifying master netting agreement, the banking organization would either include them all or exclude them all from any measure used to determine the counterparty credit risk exposure to all relevant counterparties for risk-based capital purposes.

In addition, if a banking organization provides protection through a credit derivative that is not a covered position under subpart F of the proposal, it would treat the credit derivative as an exposure to the underlying reference asset and compute a risk-weighted asset amount for the credit derivative under section 32 of the proposal. The banking organization would not be required to compute a counterparty credit risk capital requirement for the credit derivative, as long as it does so consistently and either includes all or excludes all such credit derivatives that are subject to a qualifying master netting contract from any measure used to determine counterparty credit risk exposure to all relevant counterparties for risk-based capital purposes.

Where the banking organization provides protection through a credit derivative treated as a covered position under subpart F of the proposal, it would compute a supplemental counterparty credit risk capital requirement using an amount determined under section 34 for OTC credit derivatives or section 35 for credit derivatives that are cleared transactions.

In either case, the PFE of the protection provider would be capped at the net present value of the amount of unpaid premiums.

Under the general risk-based capital rules, the risk weight applied to an OTC derivative contract is limited to 50 percent even if the counterparty or guarantor would otherwise receive a higher risk weight. Under this NPR, the risk weight for OTC derivative transactions would not be subject to any specific ceiling, consistent with the Basel capital framework. The agencies believe that as the market for derivatives has developed, the types of counterparties acceptable to participants have expanded to include counterparties that merit a risk weight greater than 50 percent.

*Question 11:* The agencies solicit comment on the proposed risk-based capital treatment for OTC derivatives, including the definition of an OTC derivative and the removal of the 50 percent cap on risk weighting for OTC derivative contracts.

#### *E. Cleared Transactions*

##### *1. Overview*

The BCBS and the agencies support clearing derivative and repo-style transactions<sup>40</sup> through a central counterparty (CCP) wherever possible in order to promote transparency, multilateral netting, and robust risk management practices.<sup>41</sup>

In general, CCPs help improve the safety and soundness of the derivatives market through the multilateral netting of exposures, establishment and enforcement of collateral requirements, and promoting market transparency. Under Basel II, exposures to a CCP arising from cleared transactions, posted collateral, clearing deposits or guaranty funds could be assigned an exposure amount of zero. However, when developing Basel III, the BCBS recognized that as more transactions move to central clearing, the potential for risk concentration and systemic risk increases. To address these concerns, the BCBS has sought comment on a more risk-sensitive approach for determining a capital requirement for a banking organization's exposures to a

<sup>40</sup> See section IL.F.2d of this preamble for a discussion of the proposed definition of a repo-style transaction.

<sup>41</sup> See, "Capitalisation of Banking Organization Exposures to Central Counterparties" (November 2011) (CCP consultative release), available at <http://www.bis.org/publ/bcbs206.pdf>. Once the CCP consultative release is finalized, the agencies expect to take into account the BCBS revisions and incorporate them into the agencies' capital rules through the regular rulemaking process, as appropriate.

CCP. In addition, to encourage CCPs to maintain strong risk management procedures, the BCBS sought comment on lower risk-based capital requirements for derivative and repo-style transaction exposures to CCPs that meet the standards established by the Committee on Payment and Settlement Systems (CPSS) and International Organization of Securities Commissions (IOSCO).<sup>42</sup>

Consistent with the proposals the Basel Committee has made on these issues and the IOSCO standards, the agencies are seeking comment on specific risk-based capital requirements for derivative and repo-style transactions that are cleared on CCPs designed to incentivize the use of CCPs, help reduce counterparty credit risk, and promote strong risk management of CCPs to mitigate their potential for systemic risk. In contrast to the general risk-based capital rules, which permit a banking organization to exclude certain derivative contracts traded on an exchange from the risk-based capital calculation, the agencies would require a banking organization to hold risk-based capital for an outstanding derivative contract or a repo-style transaction that has been entered into with all CCPs, including exchanges. Specifically, the proposal would define a cleared transaction as an outstanding derivative contract or repo-style transaction that a banking organization or clearing member has entered into with a central counterparty (that is, a transaction that a central counterparty has accepted).<sup>43</sup> Under the proposal, a banking organization would be required to hold risk-based capital for all of its cleared transactions, whether the banking organization acts as a clearing member (defined as a member of, or direct participant in, a CCP that is entitled to enter into transactions with the CCP) or a clearing member client (defined as a party to a cleared transaction associated with a CCP in which a clearing member acts either as

a financial intermediary with respect to the party or guarantees the performance of the party to the CCP).

Derivative transactions that are not cleared transactions would be OTC derivative transactions. In addition, if a transaction submitted to a CCP is not accepted by a CCP because the terms of the transaction do not match or other operational issues were identified by the CCP, the transaction would not meet the definition of a cleared transaction and would be an OTC derivative transaction. If the counterparties to the transaction resolved the issues and resubmit the transaction, and if it is accepted, the transaction could then be a cleared transaction if it satisfies all the criteria described above.

Under the proposal, a cleared transaction would include a transaction between a CCP and a clearing member banking organization for the banking organization's own account. In addition, it would include a transaction between a CCP and a clearing member banking organization acting on behalf of its client, and a transaction between a client banking organization and a clearing member where the clearing member acts on behalf of the banking organization and enters into an offsetting transaction with a CCP. A cleared transaction also includes one between a clearing member client and a CCP where a clearing member banking organization guarantees the performance of the clearing member client to the CCP. Transactions must also satisfy additional criteria provided in the definition of CCP in the proposed rule text.

Under the proposal, a cleared transaction would not include an exposure of a banking organization that is a clearing member to its clearing member client where the banking organization is either acting as a financial intermediary and enters into an offsetting transaction with a CCP or where the banking organization provides a guarantee to the CCP on the performance of the client. Such a transaction would be treated as an OTC derivative transaction with the exposure amount calculated according to section 34 of the proposal. However, the agencies recognize that this treatment may create a disincentive for banking organizations to act as intermediaries and provide access to CCPs for clients. As a result, the agencies are considering approaches that could address this disincentive while at the same time appropriately reflect the risks of these transactions. For example, one approach would allow banking organizations that are clearing members to adjust the exposure amount calculated under

section 34 downward by a certain percentage or, for advanced approaches banking organizations using the internal models method, to adjust the margin period of risk. The international discussions are ongoing on this issue and the agencies expect to revisit this issue once the Basel capital framework is revised. See also the definition of "cleared transaction" in section 2 of the proposed rules in the related notice titled "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action."

*Question 12:* The agencies request comment on whether the proposal provides an appropriately risk-sensitive treatment of (1) a transaction between a banking organization that is a clearing member and its client and (2) a clearing member's guarantee of its client's transaction with a CCP by treating these exposures as OTC derivative contracts. The agencies also request comment on whether the adjustment of the exposure amount would address possible disincentives for banking organizations that are clearing members to facilitate the clearing of their clients' transactions. What other approaches should the agencies consider?

## 2. Risk-weighted Asset Amount for Clearing Member Clients and Clearing Members

As proposed in this NPR, to determine the risk-weighted asset amount for a cleared transaction, a clearing member client or a clearing member would multiply the trade exposure amount for the cleared transaction by the appropriate risk weight, determined as described below. The trade exposure amount would be calculated as follows:

(1) For a derivative contract that is a cleared transaction, the trade exposure amount would equal the exposure amount for the derivative contract, calculated using the current exposure methodology for OTC derivative contracts under section 34 of the proposal, plus the fair value of the collateral posted by the clearing member banking organization that is held by the CCP in a manner that is not bankruptcy remote;<sup>44</sup> and

(2) For a repo-style transaction that is a cleared transaction, the trade exposure amount would equal the exposure amount calculated under the collateral

<sup>42</sup> See CPSS, "Recommendations for Central Counterparties" (November 2004), available at <http://www.bis.org/publ/cpss64.pdf?noframes=1>.

<sup>43</sup> For example, the agencies expect that a transaction with a derivatives clearing organization (DCO) would meet the proposed criteria for a cleared transaction. A DCO is a clearinghouse, clearing association, clearing corporation, or similar entity that enables each party to an agreement, contract, or transaction to substitute, through novation or otherwise, the credit of the DCO for the credit of the parties; arranges or provides, on a multilateral basis, for the settlement or netting of obligations; or otherwise provides clearing services or arrangements that mutualize or transfer credit risk among participants. To qualify as a DCO, an entity must be registered with the U.S. Commodity Futures Trading Commission and comply with all relevant laws and procedures.

<sup>44</sup> Under this proposal, bankruptcy remote, with respect to entity or asset, would mean that the entity or asset would be excluded from an insolvent entity's estate in a receivership, insolvency, liquidation, or similar proceeding.

haircut approach (described in section 37(c) of the proposal) plus the fair value of the collateral posted by the clearing member client banking organization that is held by the CCP in a manner that is not bankruptcy remote.

The trade exposure amount would not include any collateral posted by a clearing member banking organization that is held by a custodian in a manner that is bankruptcy remote from the CCP or any collateral posted by a clearing member client that is held by a custodian in a manner that is bankruptcy remote from the CCP, clearing members and other counterparties of the clearing member. In addition to the capital requirement for the cleared transaction, the banking organization would remain subject to a capital requirement for any collateral provided to a CCP, a clearing member, or a custodian in connection with a cleared transaction in accordance with section 32.

Consistent with the Basel capital framework, the agencies propose that the risk weight for a cleared transaction depends on whether the CCP is a qualifying CCP (QCCP). As proposed, central counterparties that are designated financial market utilities (FMUs) and foreign entities regulated and supervised in a manner equivalent to designated FMUs would be QCCPs. In addition, a central counterparty could be a QCCP under the proposal if it was in sound financial condition and met certain standards that are consistent with BCBS expectations for QCCPs, as set forth in the proposed definition. See the definition of “qualified central counterparty” in section 2 of the proposed rules in the related notice titled “Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action”.

Under the proposal, a clearing member banking organization would apply a 2 percent risk weight to its trade exposure amount with a QCCP. A banking organization that is a clearing member client would apply a 2 percent risk weight to the trade exposure amount only if:

(1) The collateral posted by the banking organization to the QCCP or clearing member is subject to an arrangement that prevents any losses to the clearing member due to the joint default or a concurrent insolvency, liquidation, or receivership proceeding of the clearing member and any other clearing member clients of the clearing member, and

(2) The clearing member client banking organization has conducted sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review) that in the event of a legal challenge (including one resulting from default or a liquidation, insolvency, or receivership proceeding) the relevant court and administrative authorities would find the arrangements to be legal, valid, binding, and enforceable under the law of the relevant jurisdiction.

The agencies believe that omnibus accounts (that is, accounts that are generally set up by clearing entities for non-clearing members) in the United States would satisfy these requirements because of the protections afforded client accounts under certain regulations of the SEC<sup>45</sup> and CFTC.<sup>46</sup> If the criteria above are not met, a banking organization that is clearing member client would apply a risk weight of 4 percent to the trade exposure amount.

For a cleared transaction with a CCP that is not a QCCP, a clearing member and a banking organization that is a clearing member client would risk weight the trade exposure amount to the CCP according to the treatment for the CCP under section 32 of the proposal. In addition, collateral posted by a clearing member banking organization that is held by a custodian in a manner that is bankruptcy remote from the CCP would not be subject to a capital requirement for counterparty credit risk. Collateral posted by a clearing member client that is held by a custodian in a manner that is bankruptcy remote from the CCP, clearing member, and other clearing member clients of the clearing member would not be subject to a capital requirement for counterparty credit risk.

### 3. Default Fund Contribution

One of the benefits of clearing a transaction through a CCP is the protection provided to the CCP clearing members by the margin requirements imposed by the CCP, as well as by the CCP members' default fund contributions, and the CCP's own capital and contribution to the default fund. Default funds make CCPs safer and are an important source of collateral in case of counterparty default. However, CCPs independently determine default fund contributions from members. The BCBS therefore has proposed to establish a risk-sensitive approach for risk weighting a banking organization's exposure to a default fund.

<sup>45</sup> See 15 U.S.C 78aaa–78lll and 17 CFR part 300.

<sup>46</sup> See 17 CFR part 190.

Consistent with the CCP consultative release, the agencies are proposing to require a banking organization that is a clearing member of a CCP to calculate the risk-weighted asset amount for its default fund contributions at least quarterly or more frequently if there is a material change, in the opinion of the banking organization or the primary federal supervisor, in the financial condition of the CCP. A default fund contribution would mean the funds contributed or commitments made by a clearing member to a CCP's mutualized loss-sharing arrangement.<sup>47</sup> Under this proposal, a banking organization would assign a 1,250 percent risk weight to its default fund contribution to a CCP that is not a QCCP.

As under the CCP consultative release, a banking organization would calculate a risk-weighted asset amount for its default fund contribution to a QCCP by using a three-step process. The first step is to calculate the QCCP's hypothetical capital requirement ( $K_{CCP}$ ), unless the QCCP has already disclosed it.  $K_{CCP}$  is the capital that a QCCP would be required to hold if it were a banking organization, and it is calculated using the current exposure methodology for OTC derivatives and recognizing the risk-mitigating effects of collateral posted by and default fund contributions received from the QCCP clearing members.

As a first step, for purposes of calculating  $K_{CCP}$ , the agencies are proposing several modifications to the current exposure methodology to adjust for certain features that are unique to QCCPs. First, a clearing member would be permitted to offset its exposure to a QCCP with actual default fund contributions. Second, greater recognition of netting would be allowed when calculating  $K_{CCP}$ . Specifically, the formula used to calculate the adjusted sum of the PFE amounts in section 34 (the Anet formula) would be changed from  $Anet = (0.4 \times Agross) + (0.6 \times NGR \times Agross)$  to  $Anet = (0.3 \times Agross) + (0.7 \times NGR \times Agross)$ .<sup>48</sup> Third, the risk weight of all clearing members would be set at 20 percent, except when a banking organization's primary federal supervisor has determined that a higher risk weight is appropriate based on the specific characteristics of the QCCP and

<sup>47</sup> Default funds are also known as clearing deposits or guaranty funds.

<sup>48</sup> NGR is defined as the net to gross ratio (that is, the ratio of the net current credit exposure to the gross current credit exposure). If a banking organization cannot calculate the NGR, the banking organization may use a value of 0.30 until March 31, 2013. If the CCP does not provide the NGR to the banking organization or data needed to calculate the NGR after that date, the CCP no longer meets the criteria for a QCCP.

its clearing members. Finally, for derivative contracts that are options, the PFE amount calculation would be adjusted by multiplying the notional principal amount of the derivative contract by the appropriate conversion factor and the absolute value of the option's delta (that is, the ratio of the change in the value of the derivative contract to the corresponding change in the price of the underlying asset).

In the second step,  $K_{CCP}$  is compared to the funded portion of the default fund of a QCCP and the total of all the clearing members' capital requirements ( $K_{cm}^*$ ) is calculated. If the total funded default fund of a QCCP is less than  $K_{CCP}$ , additional capital would be assessed against the shortfall because of the small size of the funded portion of the default fund relative to  $K_{CCP}$ . If the total funded default fund of a QCCP is greater than  $K_{CCP}$ , but the QCCP's own funded contributions to the default fund are less than  $K_{CCP}$  (so that the clearing members' default fund contributions are required to achieve  $K_{CCP}$ ), the clearing members' default fund contributions up to  $K_{CCP}$  would be risk-weighted at 100 percent and a decreasing capital factor, between 0.16 percent and 1.6 percent, would be applied to the clearing members' funded default fund contributions above  $K_{CCP}$ . If the QCCP's own contribution to the default fund is greater than  $K_{CCP}$ , then only the decreasing capital factor would be applied to the clearing members' default fund contributions.

In the third step, the total of all the clearing members' capital requirements ( $K_{cm}^*$ ) is allocated back to each individual clearing member. This allocation is proportional to each clearing member's contribution to the default fund but adjusted to reflect the impact of two average-size clearing members defaulting as well as to account for the concentration of exposure among clearing members.

*Question 13:* The agencies are seeking comment on the proposed calculation of the risk-based capital for cleared transactions, including the proposed risk-based capital requirements for exposures to a QCCP. Are there specific types of exposures to certain QCCPs that would warrant an alternative risk-based capital approach? Please provide a detailed description of such transactions or exposures, the mechanics of the alternative risk-based approach, and the supporting rationale.

#### F. Credit Risk Mitigation

Banking organizations use a number of techniques to mitigate credit risks. For example, a banking organization may collateralize exposures with first-

priority claims, cash or securities; a third party may guarantee a loan exposure; a banking organization may buy a credit derivative to offset an exposure's credit risk; or a banking organization may net exposures with a counterparty under a netting agreement. The general risk-based capital rules recognize these techniques to some extent. This section describes how a banking organization would recognize the risk-mitigation effects of guarantees, credit derivatives, and collateral for risk-based capital purposes under the proposal. Similar to the general risk-based capital rules, a banking organization that is not engaged in complex financial activities generally would be able to use a substitution approach to recognize the credit risk-mitigation effect of an eligible guarantee from an eligible guarantor and the simple approach to recognize the effect of collateral.

To recognize credit risk mitigants, all banking organizations should have operational procedures and risk management processes that ensure that all documentation used in collateralizing or guaranteeing a transaction is legal, valid, binding, and enforceable under applicable law in the relevant jurisdictions. A banking organization should conduct sufficient legal review to reach a well-founded conclusion that the documentation meets this standard as well as conduct additional reviews as necessary to ensure continuing enforceability.

Although the use of credit risk mitigants may reduce or transfer credit risk, it simultaneously may increase other risks, including operational, liquidity, or market risk. Accordingly, a banking organization should employ robust procedures and processes to control risks, including roll-off and concentration risks, and monitor the implications of using credit risk mitigants for the banking organization's overall credit risk profile.

#### 1. Guarantees and Credit Derivatives

##### a. Eligibility Requirements

The general risk-based capital rules generally recognize third-party guarantees provided by central governments, GSEs, PSEs in the OECD countries, multilateral lending institutions and regional development banking organizations, U.S. depository institutions, foreign banks, and qualifying securities firms in OECD countries.<sup>49</sup> Consistent with the Basel

capital framework, the agencies propose to recognize a wider range of eligible guarantors, including sovereigns, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, Federal Home Loan Banks, Federal Agricultural Mortgage Corporation (Farmer Mac), MDBs, depository institutions, bank holding companies, savings and loan holding companies, credit unions, and foreign banks. Eligible guarantors would also include entities that are not special purpose entities that have issued and outstanding unsecured debt securities without credit enhancement that are investment grade and that meet certain other requirements.<sup>50</sup> See the definition of "eligible guarantor" in section 2 of the proposed rules in the related notice titled "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action."

Under this NPR, guarantees and credit derivatives would be required to meet specific eligibility requirements to be recognized for credit risk mitigation purposes. Under the proposal an eligible guarantee would be defined as a guarantee from an eligible guarantor that is written and meets certain standards and conditions, including with respect to its enforceability. For example, an eligible guarantee must either be unconditional or a contingent obligation of the U.S. government or its agencies (the enforceability of which is dependent on some affirmative action on the part of the beneficiary of the guarantee or a third party, such as servicing requirements). See the definition of "eligible guarantee" in section 2 of the proposed rules in the related notice titled "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action."

An eligible credit derivative would be defined as a credit derivative in the form of a credit default swap, nth-to-default swap, total return swap, or any other form of credit derivative approved by the primary federal supervisor,

<sup>50</sup> Under the proposal, an exposure would be, "investment grade" if the entity to which the banking organization is exposed through a loan or security, or the reference entity with respect to a credit derivative, has adequate capacity to meet financial commitments for the projected life of the asset or exposure. Such an entity or reference entity has adequate capacity to meet financial commitments if the risk of its default is low and the full and timely repayment of principal and interest is expected.

<sup>49</sup> 12 CFR part 3, appendix A and 12 CFR 167.6 (OCC); 12 CFR parts 208 and 225, appendix A, section III.B.2 (Board); 12 CFR part 325, appendix A, section II.B.3 and 12 CFR 390.466 (FDIC).

provided that the instrument meets the standards and conditions set forth in the proposed definition. See the definition of “eligible credit derivative” in section 2 of the proposed rules in the related notice titled “Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action.”

Under this NPR, a banking organization would be permitted to recognize the credit risk mitigation benefits of an eligible credit derivative that hedges an exposure that is different from the credit derivative’s reference exposure used for determining the derivative’s cash settlement value, deliverable obligation, or occurrence of a credit event if (1) the reference exposure ranks *pari passu* with or is subordinated to the hedged exposure; and (2) the reference exposure and the hedged exposure are to the same legal entity, and legally enforceable cross-default or cross-acceleration clauses are in place to assure payments under the credit derivative are triggered when the issuer fails to pay under the terms of the hedged exposure.

When a banking organization has a group of hedged exposures with different residual maturities that are covered by a single eligible guarantee or eligible credit derivative, a banking organization would treat each hedged exposure as if it were fully covered by a separate eligible guarantee or eligible credit derivative.

#### b. Substitution Approach

Under the proposed substitution approach, if the protection amount (as defined below) of an eligible guarantee or eligible credit derivative is greater than or equal to the exposure amount of the hedged exposure, a banking organization would substitute the risk weight applicable to the guarantor or credit derivative protection provider for the risk weight assigned to the hedged exposure.

If the protection amount of the eligible guarantee or eligible credit derivative is less than the exposure amount of the hedged exposure, a banking organization would treat the hedged exposure as two separate exposures (protected and unprotected) to recognize the credit risk mitigation benefit of the guarantee or credit derivative. In such cases, a banking organization would calculate the risk-weighted asset amount for the protected exposure under section 36 (using a risk weight applicable to the guarantor or credit derivative protection provider and an exposure amount equal to the

protection amount of the guarantee or credit derivative). The banking organization would calculate its risk-weighted asset amount for the unprotected exposure under section 36 of the proposal (using the risk weight assigned to the exposure and an exposure amount equal to the exposure amount of the original hedged exposure minus the protection amount of the guarantee or credit derivative).

The protection amount of an eligible guarantee or eligible credit derivative would mean the effective notional amount of the guarantee or credit derivative (reduced to reflect any currency mismatch, maturity mismatch, or lack of restructuring coverage, as described in this section below). The effective notional amount for an eligible guarantee or eligible credit derivative would be the lesser of the contractual notional amount of the credit risk mitigant and the exposure amount of the hedged exposure, multiplied by the percentage coverage of the credit risk mitigant. For example, the effective notional amount of a guarantee that covers, on a pro rata basis, 40 percent of any losses on a \$100 bond would be \$40.

The following sections addresses credit risk mitigants with maturity mismatches, lack of restructuring coverage, currency mismatches, and multiple credit risk mitigants. A banking organization that is not engaged in complex financial transactions is unlikely to have credit risk mitigant with a currency mismatch, maturity mismatch, or lack of restructuring coverage, or multiple credit risk mitigants. In such a case, a banking organization should refer to section II.F.2 below which describes the treatment of collateralized transactions.

#### c. Maturity Mismatch Haircut

Under the proposed requirements, a banking organization that recognizes an eligible guarantee or eligible credit derivative to adjust the effective notional amount of the credit risk mitigant to reflect any maturity mismatch between the hedged exposure and the credit risk mitigant. A maturity mismatch occurs when the residual maturity of a credit risk mitigant is less than that of the hedged exposure(s).<sup>51</sup>

<sup>51</sup> As noted above, when a banking organization has a group of hedged exposures with different residual maturities that are covered by a single eligible guarantee or eligible credit derivative, a banking organization would treat each hedged exposure as if it were fully covered by a separate eligible guarantee or eligible credit derivative. To determine whether any of the hedged exposures has a maturity mismatch with the eligible guarantee or credit derivative, the banking organization would assess whether the residual maturity of the eligible

The residual maturity of a hedged exposure would be the longest possible remaining time before the obligated party of the hedged exposure is scheduled to fulfil its obligation on the hedged exposure. A banking organization would be required to take into account any embedded options that may reduce the term of the credit risk mitigant so that the shortest possible residual maturity for the credit risk mitigant would be used to determine the potential maturity mismatch. If a call is at the discretion of the protection provider, the residual maturity of the credit risk mitigant would be at the first call date. If the call is at the discretion of the banking organization purchasing the protection, but the terms of the arrangement at origination of the credit risk mitigant contain a positive incentive for the banking organization to call the transaction before contractual maturity, the remaining time to the first call date would be the residual maturity of the credit risk mitigant. For example, if there is a step-up in the cost of credit protection in conjunction with a call feature or if the effective cost of protection increases over time even if credit quality remains the same or improves, the residual maturity of the credit risk mitigant would be the remaining time to the first call date. Under this NPR, a banking organization would be permitted to recognize a credit risk mitigant with a maturity mismatch only if its original maturity is greater than or equal to one year and the residual maturity is greater than three months.

Assuming that the credit risk mitigant may be recognized, a banking organization would be required to apply the following adjustment to reduce the effective notional amount of the credit risk mitigant:  $P_m = E \times [(t-0.25)/(T-0.25)]$ , where:

- (1)  $P_m$  = effective notional amount of the credit risk mitigant, adjusted for maturity mismatch;
- (2)  $E$  = effective notional amount of the credit risk mitigant;
- (3)  $t$  = the lesser of  $T$  or residual maturity of the credit risk mitigant, expressed in years; and
- (4)  $T$  = the lesser of five or the residual maturity of the hedged exposure, expressed in years.

#### d. Adjustment for Credit Derivatives Without Restructuring as a Credit Event

Under the proposal, a banking organization that seeks to recognize an eligible credit derivative that does not include a restructuring of the hedged exposure as a credit event under the

guarantee or eligible credit derivative is less than that of the hedged exposure.

derivative would have to reduce the effective notional amount of the credit derivative recognized for credit risk mitigation purposes by 40 percent. For purposes of the proposed credit risk mitigation framework, a restructuring would involve forgiveness or postponement of principal, interest, or fees that result in a credit loss event (that is, a charge-off, specific provision, or other similar debit to the profit and loss account). In these instances, the banking organization would be required to apply the following adjustment to reduce the effective notional amount of the credit derivative:  $Pr = Pm \times 0.60$ , where:

- (1)  $Pr$  = effective notional amount of the credit risk mitigant, adjusted for lack of a restructuring event (and maturity mismatch, if applicable); and
- (2)  $Pm$  = effective notional amount of the credit risk mitigant (adjusted for maturity mismatch, if applicable).

#### e. Currency Mismatch Adjustment

Under this proposal, if a banking organization recognizes an eligible guarantee or eligible credit derivative that is denominated in a currency different from that in which the hedged exposure is denominated, the banking organization would apply the following formula to the effective notional amount of the guarantee or credit derivative:  $P_C = Pr \times (1 - H_{FX})$ , where:

- (1)  $P_C$  = effective notional amount of the credit risk mitigant, adjusted for currency mismatch (and maturity mismatch and lack of restructuring event, if applicable);
- (2)  $Pr$  = effective notional amount of the credit risk mitigant (adjusted for maturity mismatch and lack of restructuring event, if applicable); and
- (3)  $H_{FX}$  = haircut appropriate for the currency mismatch between the credit risk mitigant and the hedged exposure.

A banking organization would be required to use a standard supervisory haircut of 8 percent for  $H_{FX}$  (based on a ten-business-day holding period and daily marking-to-market and remargining). Alternatively, a banking organization would be able to use internally estimated haircuts of  $H_{FX}$  based on a ten-business-day holding period and daily marking-to-market if the banking organization qualifies to use the own-estimates of haircuts in section 37(c)(4) of the proposal. In either case, the banking organization is required to scale the haircuts up using the square root of time formula if the banking organization revalues the guarantee or credit derivative less frequently than once every 10 business days. The applicable haircut ( $H_M$ ) is calculated using the following square root of time formula:

$$H_M = 8\% \sqrt{\frac{T_M}{10}},$$

where  $T_M$  = equals the greater of 10 or the number of days between revaluation.

#### f. Multiple Credit Risk Mitigants

If multiple credit risk mitigants (for example, two eligible guarantees) cover a single exposure, the agencies propose to permit a banking organization to disaggregate the exposure into portions covered by each credit risk mitigant (for example, the portion covered by each guarantee) and calculate separately a risk-based capital requirement for each portion, consistent with the Basel capital framework. In addition, when credit risk mitigants provided by a single protection provider have differing maturities, the mitigants should be subdivided into separate layers of protection.

#### 2. Collateralized Transactions

##### a. Eligible Collateral

The general risk-based capital rules recognize limited types of collateral, such as cash on deposit; securities issued or guaranteed by central governments of the OECD countries; securities issued or guaranteed by the U.S. government or its agencies; and securities issued by certain multilateral development banks.<sup>52</sup> Given the fact that the general risk-based capital rules for collateral are restrictive and, in some cases, do not take into account market practices, the agencies propose to recognize the credit risk mitigating impact of an expanded range of financial collateral, consistent with the Basel capital framework.

As proposed, financial collateral would mean collateral in the form of: (1) Cash on deposit with the banking organization (including cash held for the banking organization by a third-party custodian or trustee); (2) gold bullion; (3) short- and long-term debt securities that are not resecuritization exposures and that are investment grade; (4) equity securities that are publicly-traded; (5) convertible bonds that are publicly-traded; or (6) money market fund shares and other mutual fund shares if a price for the shares is publicly quoted daily. With the exception of cash on deposit, the banking organization would also be required to have a perfected, first-priority security interest or, outside of

the United States, the legal equivalent thereof, notwithstanding the prior security interest of any custodial agent. A banking organization would be permitted to recognize partial collateralization of an exposure.

Under this NPR, a banking organization would be able to recognize the risk-mitigating effects of financial collateral using the simple approach, described in section II.F.2(c) below, for any exposure where the collateral is subject to a collateral agreement for at least the life of the exposure; the collateral must be revalued at least every six months; and the collateral (other than gold) and the exposure must be denominated in the same currency. For repo-style transactions, eligible margin loans, collateralized derivative contracts, and single-product netting sets of such transactions, a banking organization could alternatively use the collateral haircut approach described in section II.F.2(d) below. A banking organization would be required to use the same approach for similar exposures or transactions.

##### b. Risk Management Guidance for Recognizing Collateral

Before a banking organization recognizes collateral for credit risk mitigation purposes, it should: (1) CONDUCT sufficient legal review to ensure, at the inception of the collateralized transaction and on an ongoing basis, that all documentation used in the transaction is binding on all parties and legally enforceable in all relevant jurisdictions; (2) consider the correlation between risk of the underlying direct exposure and collateral risk in the transaction; and (3) fully take into account the time and cost needed to realize the liquidation proceeds and the potential for a decline in collateral value over this time period.

A banking organization also should ensure that the legal mechanism under which the collateral is pledged or transferred ensures that the banking organization has the right to liquidate or take legal possession of the collateral in a timely manner in the event of the default, insolvency, or bankruptcy (or other defined credit event) of the counterparty and, where applicable, the custodian holding the collateral.

In addition, a banking organization should ensure that it (1) Has taken all steps necessary to fulfill any legal requirements to secure its interest in the collateral so that it has and maintains an enforceable security interest; (2) has set up clear and robust procedures to ensure observation of any legal conditions required for declaring the default of the borrower and prompt

<sup>52</sup> The agencies' rules for collateral transactions differ somewhat as described in the agencies' joint report to Congress. See "Joint Report: Differences in Accounting and Capital Standards among the Federal Banking Agencies; Report to Congressional Committees," 75 FR 47900 (August 9, 2010).



liquidation of the collateral in the event of default; (3) has established procedures and practices for conservatively estimating, on a regular ongoing basis, the fair value of the collateral, taking into account factors that could affect that value (for example, the liquidity of the market for the collateral and obsolescence or deterioration of the collateral); and (4) has in place systems for promptly requesting and receiving additional collateral for transactions whose terms require maintenance of collateral values at specified thresholds.

#### c. Simple Approach

Under the proposed simple approach, which is similar to the general risk-based capital rules, the collateralized portion of the exposure would receive the risk weight applicable to the collateral. The collateral would be required to meet the definition of financial collateral, provided that a banking organization could recognize any collateral for a repo-style transaction that is included in the banking organization's Value-at-Risk (VaR)-based measure under the market risk capital rule. For repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions, the collateral would be the instruments, gold, and cash that a banking organization has borrowed, purchased subject to resale, or taken as collateral from the counterparty under the transaction. As noted above, in all cases, (1) The terms of the collateral agreement would be required to be equal to or greater than the life of the exposure; (2) the banking organization would be required to revalue the collateral at least every six months; and (3) the collateral (other than gold) and the exposure would be required to be denominated in the same currency.

Generally, the risk weight assigned to the collateralized portion of the exposure would be no less than 20 percent. However, the collateralized portion of an exposure could be assigned a risk weight of less than 20 percent for the following exposures. OTC derivative contracts that are marked-to-market on a daily basis and subject to a daily margin maintenance agreement, which would receive (1) a zero percent risk weight to the extent that they are collateralized by cash on deposit, or (2) a 10 percent risk weight to the extent that the contracts are collateralized by an exposure to a sovereign or a PSE that qualifies for a zero percent risk weight under section 32 of the proposal. In addition, a banking organization may assign a zero

percent risk weight to the collateralized portion of an exposure where the financial collateral is cash on deposit; or the financial collateral is an exposure to a sovereign that qualifies for a zero percent risk weight under section 32 of the proposal, and the banking organization has discounted the market value of the collateral by 20 percent.

#### d. Collateral Haircut Approach

The agencies would permit a banking organization to use a collateral haircut approach with supervisory haircuts or, with prior written approval of the primary federal supervisor, its own estimates of haircuts to recognize the risk-mitigating effect of financial collateral that secures an eligible margin loan, a repo-style transaction, collateralized derivative contract, or single-product netting set of such transactions, as well as any collateral that secures a repo-style transaction that is included in the banking organization's VaR-based measure under the market risk capital rule. A netting set would refer to a group of transactions with a single counterparty that are subject to a qualifying master netting agreement or a qualifying cross-product master netting agreement.

The proposal would define a repo-style transaction as a repurchase or reverse repurchase transaction, or a securities borrowing or securities lending transaction (including a transaction in which a banking organization acts as agent for a customer and indemnifies the customer against loss), provided that the transaction meets certain standards and conditions, including with respect to its legal status and the assets backing the transaction. For example, the transaction must be a "securities contract," "repurchase agreement" under the Bankruptcy Code or a qualified financial contract under certain provisions of U.S. banking laws, as specified in the definition. In addition, the contract must meet certain enforceability standards and a legal review of the contract must be conducted. See the definition of "repo-style transaction" in section 2 of the proposed rules in the related notice titled "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action.":

Under the proposal, an eligible margin loan would be defined as an extension of credit where certain standards and conditions are met, including with respect to collateral securing the loan and events of default in the agreements governing the loan.

See the definition of "eligible margin loan" in section 2 of the proposed rules in the related notice titled "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action."

Under the collateral haircut approach, a banking organization would determine the exposure amount using standard supervisory haircuts or its own estimates of haircuts and risk weight the exposure amount according to the counterparty or guarantor if applicable. A banking organization would set the exposure amount for an eligible margin loan, repo-style transaction, collateralized derivative contract, or a netting set of such transactions equal to the greater of zero and the sum of the following three quantities:

(1) The value of the exposure less the value of the collateral. For eligible margin loans, repo-style transactions and netting sets thereof, the value of the exposure is the sum of the current market values of all instruments, gold, and cash the banking organization has lent, sold subject to repurchase, or posted as collateral to the counterparty under the transaction or netting set. For collateralized OTC derivative contracts and netting sets thereof, the value of the exposure is the exposure amount that is calculated under section 34 of the proposal. The value of the collateral would equal the sum of the current market values of all instruments, gold and cash the banking organization has borrowed, purchased subject to resale, or taken as collateral from the counterparty under the transaction or netting set;

(2) The absolute value of the net position in a given instrument or in gold (where the net position in a given instrument or in gold equals the sum of the current market values of the instrument or gold the banking organization has lent, sold subject to repurchase, or posted as collateral to the counterparty minus the sum of the current market values of that same instrument or gold that the banking organization has borrowed, purchased subject to resale, or taken as collateral from the counterparty) multiplied by the market price volatility haircut appropriate to the instrument or gold; and

(3) The absolute values of the net position of instruments and cash in a currency that is different from the settlement currency (where the net position in a given currency equals the sum of the current market values of any instruments or cash in the currency the banking organization has lent, sold



subject to repurchase, or posted as collateral to the counterparty minus the sum of the current market values of any instruments or cash in the currency the banking organization has borrowed, purchased subject to resale, or taken as collateral from the counterparty) multiplied by the haircut appropriate to the currency mismatch.

For purposes of the collateral haircut approach, a given instrument would include, for example, all securities with

a single Committee on Uniform Securities Identification Procedures (CUSIP) number and would not include securities with different CUSIP numbers, even if issued by the same issuer with the same maturity date.

e. Standard Supervisory Haircuts

Under this NPR, a banking organization would use an 8 percent haircut for each currency mismatch and would use the market price volatility

haircut appropriate to each security as provided in table 7. The market price volatility haircuts are based on the ten-business-day holding period for eligible margin loans and derivative contracts and may be multiplied by the square root of 1/2 (which equals 0.707107) to convert the standard supervisory haircuts to the five-business-day minimum holding period for repo-style transactions.

TABLE 7—STANDARD SUPERVISORY MARKET PRICE VOLATILITY HAIRCUTS <sup>1</sup>

Residual maturity	Haircut (in percents) assigned based on:						Investment grade securitization exposures (in percent)
	Sovereign issuers risk weight under § ____ .32 <sup>2</sup>			Non-sovereign issuers risk weight under § ____ .32			
	Zero %	20% or 50%	100%	20%	50%	100%	
Less than or equal to 1 year .....	0.5	1.0	15.0	1.0	2.0	25.0	4.0
Greater than 1 year and less than or equal to 5 years .....	2.0	3.0	15.0	4.0	6.0	25.0	12.0
Greater than 5 years .....	4.0	6.0	15.0	8.0	12.0	25.0	24.0
Main index equities (including convertible bonds) and gold	15.0						Highest haircut applicable to any security in which the fund can invest. Zero.
Other publicly-traded equities (including convertible bonds)	25.0						
Mutual funds	Zero.						
Cash collateral held							

<sup>1</sup> The market price volatility haircuts in Table 2 are based on a 10 business-day holding period.

<sup>2</sup> Includes a foreign PSE that receives a zero percent risk weight.

For example, if a banking organization has extended an eligible margin loan of \$100 that is collateralized by five-year U.S. Treasury notes with a market value of \$100, the value of the exposure less the value of the collateral would be zero, and the net position in the security (\$100) times the supervisory haircut (.02) would be \$2. There is no currency mismatch. Therefore, the exposure amount would be \$0 + \$2 = \$2.

During the financial crisis, many financial institutions experienced significant delays in settling or closing out collateralized transactions, such as repo-style transactions and collateralized OTC derivatives. The assumed holding period for collateral in the collateral haircut approach under Basel II proved to be inadequate for certain transactions and netting sets and did not reflect the difficulties and delays that institutions had when settling or liquidating collateral during a period of financial stress.

Accordingly, consistent with the revised Basel capital framework, for netting sets where: (1) The number of trades exceeds 5,000 at any time during the quarter; (2) one or more trades involves illiquid collateral posted by the counterparty; or (3) the netting set includes any OTC derivatives that cannot be easily replaced, this NPR would require a banking organization to

assume a holding period of 20 business days for the collateral under the collateral haircut approach. When determining whether collateral is illiquid or an OTC derivative cannot be easily replaced for these purposes, a banking organization should assess whether, during a period of stressed market conditions, it could obtain multiple price quotes within two days or less for the collateral or OTC derivative that would not move the market or represent a market discount (in the case of collateral) or a premium (in the case of an OTC derivative).

If over the two previous quarters more than two margin disputes on a netting set have occurred that lasted longer than the holding period, then the banking organization would use a holding period for that netting set that is at least two times the minimum holding period that would otherwise be used for that netting set. Margin disputes may occur when the banking organization and its counterparty do not agree on the value of collateral or on the eligibility of the collateral provided. Margin disputes also can occur when the banking organization and its counterparty disagree on the amount of margin that is required, which could result from differences in the valuation of a transaction, or from errors in the calculation of the net exposure of a

portfolio, for instance, if a transaction is incorrectly included or excluded from the portfolio. In this NPR, the agencies propose to incorporate these adjustments to the holding period in the collateral haircut approach. However, consistent with the Basel capital framework, a banking organization would not be required to adjust the holding period upward for cleared transactions.

f. Own Estimates of Haircuts

In this NPR, the agencies are proposing to allow banking organizations to calculate market price volatility and foreign exchange volatility using own internal estimates with prior written approval of the banking organization's primary federal supervisor. The banking organization's primary federal supervisor would base approval to use internally estimated haircuts on the satisfaction of certain minimum qualitative and quantitative standards, including the requirements that a banking organization would: (1) Use a 99th percentile one-tailed confidence interval and a minimum five-business-day holding period for repo-style transactions and a minimum ten-business-day holding period for all other transactions; (2) adjust holding periods upward where and as appropriate to take into account the

illiquidity of an instrument; (3) select a historical observation period that reflects a continuous 12-month period of significant financial stress appropriate to the banking organization's current portfolio; and (4) update its data sets and compute haircuts no less frequently than quarterly, as well as any time market prices change materially. A banking organization would estimate the volatilities of each exposure, the collateral, and foreign exchange rates and not take into account the correlations between them.

Under the proposed requirements, a banking organization would be required to have policies and procedures that describe how it determines the period of significant financial stress used to calculate the bank's own internal estimates, and to be able to provide empirical support for the period used. These policies and procedures would address (1) how the banking organization links the period of significant financial stress used to calculate the own internal estimates to the composition and directional bias of the banking organization's current portfolio; and (2) the banking organization's process for selecting, reviewing, and updating the period of significant financial stress used to calculate the own internal estimates and for monitoring the appropriateness of the 12-month period in light of the bank's current portfolio. The banking organization would be required to obtain the prior approval of its primary federal supervisor for these policies and procedures and notify its primary federal supervisor if the banking organization makes any material changes to them. A banking organization's primary federal supervisor may require it to use a different period of significant financial stress in the calculation of the banking organization's own internal estimates.

Under the proposal, a banking organization would be allowed to use internally estimated haircuts for categories of debt securities under certain conditions. The banking organization would be allowed to calculate internally estimated haircuts for categories of debt securities that are investment grade exposures. The haircut for a category of securities would have to be representative of the internal volatility estimates for securities in that category that the banking organization has lent, sold subject to repurchase, posted as collateral, borrowed, purchased subject to resale, or taken as collateral.

In determining relevant categories, the banking organization would, at a

minimum, take into account (1) The type of issuer of the security; (2) the investment grade of the security; (3) the maturity of the security; and (4) the interest rate sensitivity of the security. A banking organization would calculate a separate internally estimated haircut for each individual non-investment grade debt security and for each individual equity security. In addition, a banking organization would estimate a separate currency mismatch haircut for its net position in each mismatched currency based on estimated volatilities for foreign exchange rates between the mismatched currency and the settlement currency where an exposure or collateral (whether in the form of cash or securities) is denominated in a currency that differs from the settlement currency.

#### g. Simple Value-at-risk

Under this NPR, a banking organization would not be permitted to use the simple value-at-risk (VaR) to calculate exposure amounts for eligible margin loans and repo-style transactions. However, the Basel standardized approach does incorporate the simple VaR approach for credit risk mitigants. Therefore, the agencies are considering whether to implement the simple VaR approach consistent with the requirements described below.

Under the simple VaR approach (which is not included in the NPR), with the prior written approval of its primary federal supervisor, a banking organization could be allowed to estimate the exposure amount for repo-style transactions and eligible margin loans subject to a single-product qualifying master netting agreement using a VaR model (simple VaR approach). Under the simple VaR approach, a banking organization's exposure amount for transactions subject to such a netting agreement would be equal to the value of the exposures minus the value of the collateral plus a VaR-based estimate of the PFE. The value of the exposures would be the sum of the current market values of all instruments, gold, and cash the banking organization has lent, sold subject to repurchase, or posted as collateral to a counterparty under the netting set. The value of the collateral would be the sum of the current market values of all instruments, gold, and cash the banking organization has borrowed, purchased subject to resale, or taken as collateral from a counterparty under the netting set. The VaR-based estimate of the PFE would be an estimate of the banking organization's maximum exposure on the netting set over a fixed

time horizon with a high level of confidence.

To qualify for the simple VaR approach, a banking organization's VaR model would have to estimate the banking organization's 99th percentile, one-tailed confidence interval for an increase in the value of the exposures minus the value of the collateral ( $\Sigma E - \Sigma C$ ) over a five-business-day holding period for repo-style transactions or over a ten-business-day holding period for eligible margin loans using a minimum one-year historical observation period of price data representing the instruments that the banking organization has lent, sold subject to repurchase, posted as collateral, borrowed, purchased subject to resale, or taken as collateral. The main ongoing qualification requirement for using a VaR model is that the banking organization would have to validate its VaR model by establishing and maintaining a rigorous and regular backtesting regime.

*Question 14:* The agencies solicit comments on whether banking organizations should be permitted to use the simple VaR to calculate exposure amounts for margin lending, and repo-style transactions.

#### h. Internal Models Methodology

The advanced approaches rule include an internal models methodology for the calculation of the exposure amount for the counterparty credit exposure for OTC derivatives, eligible margin loans, and repo-style transactions.<sup>53</sup> This methodology requires a risk model that captures counterparty credit risk and estimates the exposure amount at the level of a netting set. A banking organization may use the internal models methodology for OTC derivatives, eligible margin loans, and repo-style transactions. In the companion NPR, the agencies are proposing to permit a banking organization subject to the advanced approaches risk-based capital rules to use the internal models methodology to calculate the trade exposure amount for cleared transactions.<sup>54</sup>

<sup>53</sup> See 72 FR 69288, 69346 (December 7, 2007).

<sup>54</sup> The internal models methodology is fully discussed in the 2007 **Federal Register** notice of the advanced approaches rule, with specific references at: (1) 72 FR 69346–69349 and 69302–69321; (2) section 22(c) and other paragraphs in section 22 of the common rule text (at 72 FR 69413–69416; sections 22 (a)(2) and (3), (i), (j), and (k) (these sections establish the qualification requirements for the advanced systems in general and therefore would apply to the expected positive exposure modeling approach as part of the internal models methodology); (3) sections 32(c) and (d) of the common rule text (at 72 FR 69413–69416); (4) applicable definitions in section 2 of the common rule text (at 72 FR 69397–69405); and (5) applicable

Although the internal models methodology is not part of this proposal, the Basel standardized approach does incorporate an internal models methodology for credit risk mitigants. Therefore, the agencies are considering whether to implement the internal models methodology in a final rule consistent with the requirements in the advanced approaches rule as modified by the companion NPR.

*Question 15:* The agencies request comment on the appropriateness of including the internal models methodology for calculating exposure amounts for OTC derivatives, eligible margin loans, repo-style transactions and cleared transactions for all banking organizations. For purposes of reviewing the internal models methodology in the advanced approaches rule, commenters should substitute the term “exposure amount” for the term “exposure at default” and “EAD” each time these terms appear in the advanced approaches rule.)

#### G. Unsettled Transactions

In this NPR, the agencies propose to provide for a separate risk-based capital requirement for transactions involving securities, foreign exchange instruments, and commodities that have a risk of delayed settlement or delivery. The proposed capital requirement would not, however, apply to certain types of transactions, including: (1) Cleared transactions that are marked-to-market daily and subject to daily receipt and payment of variation margin; (2) repo-style transactions, including unsettled repo-style transactions; (3) one-way cash payments on OTC derivative contracts; or (4) transactions with a contractual settlement period that is longer than the normal settlement period (which the proposal defines as the lesser of the market standard for the particular instrument or five business days).<sup>55</sup> Under the proposal, in the case of a system-wide failure of a settlement, clearing system, or central counterparty, the banking organization’s primary federal supervisor may waive risk-based capital requirements for unsettled and failed transactions until the situation is rectified.

This NPR proposes separate treatments for delivery-versus-payment (DvP) and payment-versus-payment (PvP) transactions with a normal

settlement period, and non-DvP/non-PvP transactions with a normal settlement period. A DvP transaction would refer to a securities or commodities transaction in which the buyer is obligated to make payment only if the seller has made delivery of the securities or commodities and the seller is obligated to deliver the securities or commodities only if the buyer has made payment. A PvP transaction would mean a foreign exchange transaction in which each counterparty is obligated to make a final transfer of one or more currencies only if the other counterparty has made a final transfer of one or more currencies. A transaction would be considered to have a normal settlement period if the contractual settlement period for the transaction is equal to or less than the market standard for the instrument underlying the transaction and equal to or less than five business days.

A banking organization would be required to hold risk-based capital against a DvP or PvP transaction with a normal settlement period if the banking organization’s counterparty has not made delivery or payment within five business days after the settlement date. The banking organization would determine its risk-weighted asset amount for such a transaction by multiplying the positive current exposure of the transaction for the banking organization by the appropriate risk weight in table 8. The positive current exposure from an unsettled transaction of a banking organization would be the difference between the transaction value at the agreed settlement price and the current market price of the transaction, if the difference results in a credit exposure of the banking organization to the counterparty.

TABLE 8—PROPOSED RISK WEIGHTS FOR UNSETTLED DVP AND PVP TRANSACTIONS

Number of business days after contractual settlement date	Risk weight to be applied to positive current exposure (in percent)
From 5 to 15 .....	100.0
From 16 to 30 .....	625.0
From 31 to 45 .....	937.5
46 or more .....	1,250.0

A banking organization would hold risk-based capital against any non-DvP/non-PvP transaction with a normal settlement period if the banking organization delivered cash, securities, commodities, or currencies to its counterparty but has not received its corresponding deliverables by the end

of the same business day. The banking organization would continue to hold risk-based capital against the transaction until it has received the corresponding deliverables. From the business day after the banking organization has made its delivery until five business days after the counterparty delivery is due, the banking organization would calculate the risk-weighted asset amount for the transaction by risk weighting the current market value of the deliverables owed to the banking organization, using the risk weight appropriate for an exposure to the counterparty in accordance with section 32. If a banking organization has not received its deliverables by the fifth business day after the counterparty delivery due date, the banking organization would assign a 1,250 percent risk weight to the current market value of the deliverables owed.

*Question 16:* Are there other transactions with a CCP that the agencies should consider excluding from the treatment for unsettled transactions? If so, what are the specific transaction types that should be excluded and why would exclusion be appropriate?

#### H. Risk-weighted Assets for Securitization Exposures

Under the general risk-based capital rules, a banking organization may use external ratings issued by NRSROs to assign risk weights to certain recourse obligations, residual interests, direct credit substitutes, and asset- and mortgage-backed securities. Such exposures to securitization transactions may also be subject to capital requirements that can result in effective risk weights of 1,250 percent, or a dollar-for-dollar capital requirement. A banking organization must deduct certain credit-enhancing interest-only strips (CEIOS) from tier 1 capital.<sup>56</sup> In this NPR, the agencies are updating the terminology of the securitization framework and proposing a broader definition of a securitization exposure to encompass a wider range of exposures with similar risk characteristics.

As noted in the introduction section of this preamble, the Basel capital framework has maintained the use and reliance on credit ratings in the

<sup>56</sup> See 12 CFR part 3, appendix A, section 4 and 12 CFR 167.12 (OCC); 12 CFR parts 208 and 225 appendix A, section III.B.3 (Board); 12 CFR part 325, appendix A section II.B.1 and 12 CFR 390.471 (FDIC). The agencies also have published a significant amount of supervisory guidance to assist banking organizations with the capital treatment of securitization exposures. In general, the agencies expect banking organizations to continue to use this guidance, most of which would remain applicable to the securitization framework proposed in this NPR.

disclosure requirements in Tables 11.6 and 11.7 of the common rule text (at 72 FR 69443). In addition, the Advanced Approaches and Market Risk NPR proposes modifications to the internal models methodology.

<sup>55</sup> Such transactions would be treated as derivative contracts as provided in section 34 or section 35 of the proposal.

securitization framework. In accordance with the Dodd-Frank Act requirement to remove references to and reliance on credit ratings, the agencies have developed alternative standards of creditworthiness for use in the securitization framework that, where possible and to the extent appropriate, have been designed to be similar to the requirements prescribed by the BCBS. These proposed alternative standards are also consistent with those incorporated into the market risk capital rules, under the agencies' final rule.<sup>57</sup>

#### 1. Overview of the Securitization Framework and Definitions

The proposed securitization framework is designed to address the credit risk of exposures that involve the tranching of the credit risk of one or more underlying financial exposures. The agencies believe that requiring all or substantially all of the underlying exposures of a securitization be financial exposures creates an important boundary between the general credit risk framework and the securitization framework. Examples of financial exposures include loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities. Based on their cash flow characteristics, for purposes of this proposal, the agencies also would consider asset classes such as lease residuals and entertainment royalties to be financial assets.

The securitization framework is designed to address the tranching of the credit risk of financial exposures and is not designed, for example, to apply to tranching credit exposures to commercial or industrial companies or nonfinancial assets. Accordingly, under this NPR, a specialized loan to finance the construction or acquisition of large-scale projects (for example, airports or power plants), objects (for example, ships, aircraft, or satellites), or commodities (for example, reserves, inventories, precious metals, oil, or natural gas) generally would not be a securitization exposure because the assets backing the loan typically are nonfinancial assets (the facility, object, or commodity being financed).

Proposed definition of securitization exposure would include on- or off-balance sheet credit exposure (including credit-enhancing representations and warranties) that arises from a traditional or synthetic securitization (including a resecuritization), or an exposure that

directly or indirectly references a securitization exposure. A traditional securitization means a transaction in which credit risk has been transferred to one or more third parties, the credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority, and certain other conditions are met, such as a measurement that all or substantially all of the underlying exposures are financial exposures. See the definition of "traditional securitization" in section 2 of the proposed rules in the related notice titled "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action."

Paragraph (10) of the proposed definition would specifically exclude from the definition exposures to investment funds (as defined in the proposal) and collective investment and pension funds (as defined in relevant regulations and set forth in the proposed definition of "traditional securitization"). These specific exemptions provided in paragraph (10) serve to narrow the potential scope of the securitization framework. Investment funds, collective investment funds, pension funds regulated under ERISA and their foreign equivalents, and transactions regulated under the Investment Company Act of 1940 and their foreign equivalents are exempted from the definition because these entities and transactions are tightly regulated and subject to strict leverage requirements. For purposes of this proposal, an investment fund is a company (1) where all or substantially all of the assets of the fund are financial assets; and (2) that has no material liabilities. In addition, the agencies believe that the capital requirements for an extension of credit to, or an equity holding in these transactions are more appropriately calculated under the rules for corporate and equity exposures, and that the securitization framework was not intended to apply to such transactions.

Under the proposal, an operating company would not fall under the definition of a traditional securitization (even if substantially all of its assets are financial exposures). For purposes of the proposed definition of a traditional securitization, operating companies generally would refer to companies that are set up to conduct business with clients with the intention of earning a profit in their own right and generally produce goods or provide services beyond the business of investing,

reinvesting, holding, or trading in financial assets. Accordingly, an equity investment in an operating company, such as a banking organization, generally would be an equity exposure under the proposal. In addition, investment firms that generally do not produce goods or provide services beyond the business of investing, reinvesting, holding, or trading in financial assets, would not be operating companies for purposes of this proposal and would not qualify for this general exclusion from the definition of traditional securitization.

To address the treatment of investment firms, the primary federal supervisor of a banking organization, under paragraph (8) of the definition of traditional securitization, would have discretion to exclude from the definition of a traditional securitization those transactions in which the underlying exposures are owned by an investment firm that exercise substantially unfettered control over the size and composition of its assets, liabilities, and off-balance sheet exposures. The agencies would consider a number of factors in the exercise of this discretion, including the assessment of the transaction's leverage, risk profile, and economic substance. This supervisory exclusion would give the primary federal supervisor discretion to distinguish structured finance transactions, to which the securitization framework was designed to apply, from those of flexible investment firms such as certain hedge funds and private equity funds. Only investment firms that can easily change the size and composition of their capital structure, as well as the size and composition of their assets and off-balance sheet exposures, would be eligible for the exclusion from the definition of traditional securitization under this provision. The agencies do not consider managed collateralized debt obligation vehicles, structured investment vehicles, and similar structures, which allow considerable management discretion regarding asset composition but are subject to substantial restrictions regarding capital structure, to have substantially unfettered control. Thus, such transactions would meet the definition of traditional securitization.

The agencies are concerned that the line between securitization exposures and non-securitization exposures may be difficult to draw in some circumstances. In addition to the supervisory exclusion from the definition of traditional securitization described above, the primary federal supervisor may scope certain transactions into the securitization

<sup>57</sup> See "Risk-Based Capital Guidelines: Market Risk," June 7, 2012 (Federal Register publication forthcoming).

framework if justified by the economics of the transaction. Similar to the analysis for excluding an investment firm from treatment as a traditional securitization, the agencies would consider the economic substance, leverage, and risk profile of transactions to ensure that the appropriate risk-based capital treatment. The agencies would consider a number of factors when assessing the economic substance of a transaction including, for example, the amount of equity in the structure, overall leverage (whether on- or off-balance sheet), whether redemption rights attach to the equity investor, and the ability of the junior tranches to absorb losses without interrupting contractual payments to more senior tranches.

Both the designation of exposures as securitization (or resecuritization) exposures and the calculation of risk-based capital requirements for securitization exposures would be guided by the economic substance of a transaction rather than its legal form. Provided there is a tranching of credit risk, securitization exposures could include, among other things, asset-backed and mortgage-backed securities, loans, lines of credit, liquidity facilities, financial standby letters of credit, credit derivatives and guarantees, loan servicing assets, servicer cash advance facilities, reserve accounts, credit-enhancing representations and warranties, and CEIOs. Securitization exposures also could include assets sold with retained tranches. Mortgage-backed pass-through securities (for example, those guaranteed by FHLMC or FNMA) do not meet the proposed definition of a securitization exposure because they do not involve a tranching of credit risk. Only those mortgage-backed securities that involve tranching of credit risk would be securitization exposures.

Under the proposal, a synthetic securitization would mean a transaction in which: (1) All or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties through the use of one or more credit derivatives or guarantees (other than a guarantee that transfers only the credit risk of an individual retail exposure); (2) the credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority; (3) performance of the securitization exposures depends upon the performance of the underlying exposures; and (4) all or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed

securities, mortgage-backed securities, other debt securities, or equity securities).

Consistent with 2009 Enhancements, this NPR would define a resecuritization exposure as an on- or off-balance sheet exposure to a resecuritization; or an exposure that directly or indirectly references a resecuritization exposure. An exposure to an asset-backed commercial paper program (ABCP) would not be a resecuritization exposure if either: (1) The program-wide credit enhancement does not meet the definition of a resecuritization exposure; or (2) the entity sponsoring the program fully supports the commercial paper through the provision of liquidity so that the commercial paper holders effectively are exposed to the default risk of the sponsor instead of the underlying exposures. A resecuritization would mean a securitization in which one or more of the underlying exposures is a securitization exposure. If a transaction involves a traditional multi-seller ABCP, also discussed in more detail below, a banking organization would need to determine whether the transaction should be considered a resecuritization exposure. For example, assume that an ABCP conduit acquires securitization exposures where the underlying assets consist of wholesale loans and no securitization exposures. As is typically the case in multi-seller ABCP conduits, each seller provides first-loss protection by over-collateralizing the conduit to which it sells its loans. To ensure that the commercial paper issued by each conduit is highly-rated, a banking organization sponsor provides either a pool-specific liquidity facility or a program-wide credit enhancement such as a guarantee to cover a portion of the losses above the seller-provided protection.

The pool-specific liquidity facility generally would not be treated as a resecuritization exposure under this proposal because the pool-specific liquidity facility represents a tranche of a single asset pool (that is, the applicable pool of wholesale exposures), which contains no securitization exposures. However, a sponsor's program-wide credit enhancement that does not cover all losses above the seller-provided credit enhancement across the various pools generally would constitute tranching of risk of a pool of multiple assets containing at least one securitization exposure, and therefore would be treated as a resecuritization exposure.

In addition, if the conduit in this example funds itself entirely with a single class of commercial paper, then

the commercial paper generally would not be considered a resecuritization exposure if either (1) the program-wide credit enhancement did not meet the proposed definition of a resecuritization exposure or (2) the commercial paper was fully supported by the sponsoring banking organization. When the sponsoring banking organization fully supports the commercial paper, the commercial paper holders effectively would be exposed to default risk of the sponsor instead of the underlying exposures, and the external rating of the commercial paper would be expected to be based primarily on the credit quality of the banking organization sponsor, thus ensuring that the commercial paper does not represent a tranching risk position.

## 2. Operational Requirements

### a. Due Diligence Requirements

During the recent financial crisis, it became apparent that many banking organizations relied exclusively on NRSRO ratings and did not perform their own credit analysis of the securitization exposures. Accordingly, and consistent with the Basel capital framework, banking organizations would be required under the proposal to satisfy specific due diligence requirements for securitization exposures. Specifically, a banking organization would be required to demonstrate, to the satisfaction of its primary federal supervisor, a comprehensive understanding of the features of a securitization exposure that would materially affect the performance of the exposure. The banking organization's analysis would be required to be commensurate with the complexity of the exposure and the materiality of the exposure in relation to capital. If the banking organization is not able to demonstrate a comprehensive understanding of a securitization exposure to the satisfaction of its primary federal supervisor, the banking organization would be required to assign a risk weight of 1,250 percent to the exposure.

Under the proposal, to demonstrate a comprehensive understanding of a securitization exposure a banking organization would have to conduct and document an analysis of the risk characteristics of the exposure prior to acquisition and periodically thereafter. This analysis would consider:

(1) Structural features of the securitization that would materially impact the performance of the exposure, for example, the contractual cash flow waterfall, waterfall-related triggers, credit enhancements, liquidity

enhancements, market value triggers, the performance of organizations that service the position, and deal-specific definitions of default;

(2) Relevant information regarding the performance of the underlying credit exposure(s), for example, the percentage of loans 30, 60, and 90 days past due; default rates; prepayment rates; loans in foreclosure; property types; occupancy; average credit score or other measures of creditworthiness; average LTV ratio; and industry and geographic diversification data on the underlying exposure(s);

(3) Relevant market data of the securitization, for example, bid-ask spread, most recent sales price and historical price volatility, trading volume, implied market rating, and size, depth and concentration level of the market for the securitization; and

(4) For resecuritization exposures, performance information on the underlying securitization exposures, for example, the issuer name and credit quality, and the characteristics and performance of the exposures underlying the securitization exposures.

On an ongoing basis (no less frequently than quarterly), a banking organization would be required to evaluate, review, and update as appropriate the analysis required under section 41(c)(1) for each securitization exposure.

*Question 17:* What, if any, are specific challenges that are involved with meeting the proposed due diligence requirements and for what types of securitization exposures? How might the agencies address these challenges while ensuring that a banking organization conducts an appropriate level of due diligence commensurate with the risks of its exposures?

#### b. Operational Requirements for Traditional Securitizations

In a traditional securitization, an originating banking organization typically transfers a portion of the credit risk of exposures to third parties by selling them to a securitization special purpose entity (SPE) (as defined in the proposal).<sup>58</sup> Under this NPR, a banking organization would be an originating banking organization if it: (1) Directly or indirectly originated or securitized the underlying exposures included in the

<sup>58</sup> The proposal would define a securitization SPE as a corporation, trust, or other entity organized for the specific purpose of holding underlying exposures of a securitization, the activities of which are limited to those appropriate to accomplish this purpose, and the structure of which is intended to isolate the underlying exposures held by the entity from the credit risk of the seller of the underlying exposures to the entity.

securitization; or (2) serves as an ABCP program sponsor to the securitization.

Under the proposal, a banking organization that transfers exposures it has originated or purchased to a securitization SPE or other third party in connection with a traditional securitization may exclude the underlying exposures from the calculation of risk-weighted assets only if each of the following conditions are met: (1) The exposures are not reported on the banking organization's consolidated balance sheet under GAAP; (2) the banking organization has transferred to one or more third parties credit risk associated with the underlying exposures; and (3) any clean-up calls relating to the securitization are eligible clean-up calls (as discussed below). An originating banking organization that meets these conditions would hold risk-based capital against any securitization exposures it retains in connection with the securitization. An originating banking organization that fails to meet these conditions would be required to hold risk-based capital against the transferred exposures as if they had not been securitized and would deduct from common equity tier 1 capital any after-tax gain-on-sale resulting from the transaction.

In addition, if a securitization includes one or more underlying exposures in which (1) the borrower is permitted to vary the drawn amount within an agreed limit under a line of credit, and (2) contains an early amortization provision, the originating banking organization would be required to hold risk-based capital against the transferred exposures as if they had not been securitized and deduct from common equity tier 1 capital any after-tax gain-on-sale resulting from the transaction.<sup>59</sup> The agencies believe that

<sup>59</sup> Many securitizations of revolving credit facilities (for example, credit card receivables) contain provisions that require the securitization to be wound down and investors to be repaid if the excess spread falls below a certain threshold. This decrease in excess spread may, in some cases, be caused by deterioration in the credit quality of the underlying exposures. An early amortization event can increase a banking organization's capital needs if new draws on the revolving credit facilities need to be financed by the banking organization using on-balance sheet sources of funding. The payment allocations used to distribute principal and finance charge collections during the amortization phase of these transactions also can expose a banking organization to a greater risk of loss than in other securitization transactions. The proposed rule would define early amortization as a provision in a securitization's governing documentation that, when triggered, causes investors in the securitization exposures to be repaid before the original stated maturity of the securitization exposure, unless the provision is solely triggered by events not related to the performance of the

this treatment is appropriate given the lack of risk transference in securitizations that contain early amortization provisions.

#### c. Operational Requirements for Synthetic Securitizations

In general, the proposal's treatment of synthetic securitizations is similar to that of traditional securitizations. The operational requirements for synthetic securitizations, however, are more rigorous to ensure that the originating banking organization has truly transferred credit risk of the underlying exposures to one or more third parties.

For synthetic securitizations, an originating banking organization would recognize for risk-based capital purposes the use of a credit risk mitigant to hedge underlying exposures only if each of the conditions in the proposed definition of "synthetic securitization" is satisfied. These conditions include requirements with respect to the type and contractual governance of the credit risk mitigant used in the transaction. For example, the credit risk associated with the underlying exposures must be separated into at least two tranches reflecting different levels of seniority and all or substantially all of the underlying exposures are financial exposures. See the definition of "synthetic securitization" in section 2 of the proposed rules in the related notice titled "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action."

Failure to meet these operational requirements for a synthetic securitization would prevent a banking organization from using the proposed securitization framework and would require the banking organization to hold risk-based capital against the underlying exposures as if they had not been synthetically securitized. A banking organization that provides credit protection to a synthetic securitization would use the securitization framework to compute risk-based capital requirements for its exposures to the synthetic securitization even if the originating banking organization failed to meet one or more of the operational requirements for a synthetic securitization.

underlying exposures or the originating banking organization (such as material changes in tax laws or regulations).

#### d. Clean-Up Calls

To satisfy the operational requirements for securitizations and enable an originating banking organization to exclude the underlying exposures from the calculation of its risk-based capital requirements, any clean-up call associated with a securitization would need to be an eligible clean-up call. The proposal would define a clean-up call as a contractual provision that permits an originating banking organization or servicer to call securitization exposures before their stated maturity or call date. In the case of a traditional securitization, a clean-up call generally is accomplished by repurchasing the remaining securitization exposures once the amount of underlying exposures or outstanding securitization exposures falls below a specified level. In the case of a synthetic securitization, the clean-up call may take the form of a clause that extinguishes the credit protection once the amount of underlying exposures has fallen below a specified level.

Under the proposal, an eligible clean-up call would be a clean-up call that (1) is exercisable solely at the discretion of the originating banking organization or servicer; (2) is not structured to avoid allocating losses to securitization exposures held by investors or otherwise structured to provide credit enhancement to the securitization (for example, to purchase non-performing underlying exposures); and (3) for a traditional securitization, is only exercisable when 10 percent or less of the principal amount of the underlying exposures or securitization exposures (determined as of the inception of the securitization) is outstanding; or, for a synthetic securitization, is only exercisable when 10 percent or less of the principal amount of the reference portfolio of underlying exposures (determined as of the inception of the securitization) is outstanding. Where a securitization SPE is structured as a master trust, a clean-up call with respect to a particular series or tranche issued by the master trust would meet criteria (3) of the definition of "eligible clean-up call" as long as the outstanding principal amount in that series was 10 percent or less of its original amount at the inception of the series.

#### 3. Risk-weighted Asset Amounts for Securitization Exposures

Under the proposed securitization framework, a banking organization generally would calculate a risk-weighted asset amount for a securitization exposure by applying

either (1) the simplified supervisory formula approach (SSFA), described in section II.H.4 of this preamble, or (2) for banking organizations that are not subject to the market risk rule, a gross-up approach similar to an approach provided under the general risk-based capital rules. A banking organization would be required to apply either the gross-up approach or the SSFA consistently across all of its securitization exposures. Alternatively, a banking organization may choose to apply a 1,250 percent risk weight to any of its securitization exposures. In addition, the proposal provides for alternative treatment of securitization exposures to ABCP liquidity facilities and certain gains-on-sales and CEIO exposures. The proposed requirements, similar to the general risk-based capital rules, would include exceptions for interest-only mortgage-backed securities, certain statutorily exempted assets, and certain derivatives as described below. In all cases, the minimum risk weight for securitization exposures would be 20 percent.

For synthetic securitizations, which typically employ credit derivatives, a banking organization would apply the securitization framework when calculating risk-based capital requirements. Under this NPR, a banking organization may use the securitization CRM rules to adjust the capital requirement under the securitization framework for an exposure to reflect the CRM technique used in the transaction.

#### a. Exposure Amount of a Securitization Exposure

Under this proposal, the exposure amount of an on-balance sheet securitization exposure that is not a repo-style transaction, eligible margin loan, OTC derivative contract or derivative that is a cleared transaction (other than a credit derivative) would be the banking organization's carrying value of the exposure. The exposure amount of an off-balance sheet securitization exposure that is not an eligible ABCP liquidity facility, a repo-style transaction, eligible margin loan, an OTC derivative contract, or a derivative that is a cleared transaction (other than a credit derivative) would be the notional amount of the exposure.

For purposes of calculating the exposure amount of off-balance sheet exposure to an ABCP securitization exposure, such as a liquidity facility, the notional amount may be reduced to the maximum potential amount that the banking organization could be required to fund given the ABCP program's current underlying assets (calculated

without regard to the current credit quality of those assets). Thus, if \$100 is the maximum amount that could be drawn given the current volume and current credit quality of the program's assets, but the maximum potential draw against these same assets could increase to as much as \$200 under some scenarios if their credit quality were to deteriorate, then the exposure amount is \$200. This NPR would define an ABCP program as a program established primarily for the purpose of issuing commercial paper that is investment grade and backed by underlying exposures held in a securitization SPE. An eligible ABCP liquidity facility would be defined as a liquidity facility supporting ABCP, in form or in substance, that is subject to an asset quality test at the time of draw that precludes funding against assets that are 90 days or more past due or in default. Notwithstanding these eligibility requirements, a liquidity facility would be an eligible ABCP liquidity facility if the assets or exposures funded under the liquidity facility that do not meet the eligibility requirements are guaranteed by a sovereign entity that qualifies for a 20 percent risk weight or lower.

The exposure amount of an eligible ABCP liquidity facility that is subject to the SSFA would be the notional amount of the exposure multiplied by a 100 percent CCF. The exposure amount of an eligible ABCP liquidity facility that is not subject to the SSFA would be the notional amount of the exposure multiplied by a 50 percent CCF. The proposed CCF for eligible ABCP liquidity facilities with an original maturity of less than one year is greater than the 10 percent CCF prescribed under the general risk-based capital rules.

The exposure amount of a securitization exposure that is a repo-style transaction, eligible margin loan, an OTC derivative or derivative that is a cleared transaction (other than a credit derivative) would be the exposure amount of the transaction as calculated in section 34 or section 37 as applicable.

#### b. Gains-On-Sale and Credit-Enhancing Interest-Only Strips

Under this NPR and the Basel III NPR, a banking organization would deduct from common equity tier 1 capital any after-tax gain-on-sale resulting from a securitization and would apply a 1,250 percent risk weight to the portion of a credit-enhancing interest-only strip (CEIO) that does not constitute an after-tax gain-on-sale. The agencies believe this treatment is appropriate given historical supervisory concerns with the



subjectivity involved in valuations of gains-on-sale and CEOs. Furthermore, although the treatments for gains-on-sale and CEOs can increase an originating banking organization's risk-based capital requirement following a securitization, the agencies believe that such anomalies would be rare where a securitization transfers significant credit risk from the originating banking organization to third parties.

#### c. Exceptions Under the Securitization Framework

There are several exceptions to the general provisions in the securitization framework that parallel the general risk-based capital rules. First, a banking organization would be required to assign a risk weight of at least 100 percent to an interest-only mortgage-backed security. The agencies believe that a minimum risk weight of 100 percent is prudent in light of the uncertainty implied by the substantial price volatility of these securities. Second, as required by federal statute, a special set of rules would continue to apply to securitizations of small-business loans and leases on personal property transferred with retained contractual exposure by well-capitalized depository institutions.<sup>60</sup> Finally, under this NPR, if a securitization exposure is an OTC derivative contract or derivative contract that is a cleared transaction (other than a credit derivative) that has a first priority claim on the cash flows from the underlying exposures (notwithstanding amounts due under interest rate or currency derivative contracts, fees due, or other similar payments), a banking organization may choose to set the risk-weighted asset amount of the exposure equal to the amount of the exposure. This treatment would be subject to supervisory approval.

#### d. Overlapping Exposures

This NPR includes provisions to limit the double counting of risks in situations involving overlapping securitization exposures. If a banking organization has multiple securitization exposures that provide duplicative coverage to the underlying exposures of a securitization (such as when a banking organization provides a program-wide credit enhancement and multiple pool-

<sup>60</sup> See 12 U.S.C. 1835. This provision places a cap on the risk-based capital requirement applicable to a well-capitalized depository institution that transfers small-business loans with recourse. This NPR does not expressly provide that the agencies may permit adequately capitalized banking organizations to use the small business recourse rule on a case-by-case basis because the agencies may make such a determination under the general reservation of authority in section 1 of the proposal.

specific liquidity facilities to an ABCP program), the banking organization would not be required to hold duplicative risk-based capital against the overlapping position. Instead, the banking organization would apply to the overlapping position the applicable risk-based capital treatment under the securitization framework that results in the highest risk-based capital requirement.

#### e. Servicer Cash Advances

A traditional securitization typically employs a servicing banking organization that, on a day-to-day basis, collects principal, interest, and other payments from the underlying exposures of the securitization and forwards such payments to the securitization SPE or to investors in the securitization. Servicing banking organizations often provide a facility to the securitization under which the servicing banking organization may advance cash to ensure an uninterrupted flow of payments to investors in the securitization, including advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the underlying exposures. These servicer cash advance facilities are securitization exposures.

A banking organization would either apply the SSFA or the gross-up approach, as described below, or a 1,250 percent risk weight to its exposure under the facility. The treatment of the undrawn portion of the facility would depend on whether the facility is an eligible servicer cash advance facility. An eligible servicer cash advance facility would be defined as a servicer cash advance facility in which: (1) The servicer is entitled to full reimbursement of advances, except that a servicer may be obligated to make non-reimbursable advances for a particular underlying exposure if any such advance is contractually limited to an insignificant amount of the outstanding principal balance of that exposure; (2) the servicer's right to reimbursement is senior in right of payment to all other claims on the cash flows from the underlying exposures of the securitization; and (3) the servicer has no legal obligation to, and does not make, advances to the securitization if the servicer concludes the advances are unlikely to be repaid.

Consistent with the general risk-based capital rules with respect to the treatment of residential mortgage servicer cash advances, a servicing banking organization would not be required to hold risk-based capital against the undrawn portion of an eligible servicer cash advance facility. A

banking organization that provides a non-eligible servicer cash advance facility would determine its risk-based capital requirement for the notional amount of the undrawn portion of the facility in the same manner as the banking organization would determine its risk-based capital requirement for any other off-balance sheet securitization exposure.

#### f. Implicit Support

This NPR specifies consequence for a banking organization's risk-based capital requirements if the banking organization provides support to a securitization in excess of the banking organization's predetermined contractual obligation (implicit support). First, similar to the general risk-based capital rules, a banking organization that provides such implicit support would include in risk-weighted assets all of the underlying exposures associated with the securitization as if the exposures had not been securitized, and deduct from common equity tier 1 capital any after-tax gain-on-sale resulting from the securitization.<sup>61</sup> Second, the banking organization would disclose publicly (i) that it has provided implicit support to the securitization, and (ii) the risk-based capital impact to the banking organization of providing such implicit support. Under the proposed reservations of authority, the banking organization's primary federal supervisor also could require the banking organization to hold risk-based capital against all the underlying exposures associated with some or all the banking organization's other securitizations as if the exposures had not been securitized, and to deduct from common equity tier 1 capital any after-tax gain-on-sale resulting from such securitizations.

#### 4. Simplified Supervisory Formula Approach

For purposes of this proposal, and consistent with the approach provided for assigning specific risk-weighting factors to securitization exposures under subpart F, the agencies have developed a simplified version of the advanced approaches supervisory formula approach (SFA) to assign risk weights to securitization exposures.<sup>62</sup> This

<sup>61</sup> "Interagency Guidance on Implicit Recourse in Asset Securitizations," (May 23, 2002). OCC Bulletin 2002-20; CEO Memo No. 162 (OCC); SR letter 02-15 (Board); and FIL-52-2002 (FDIC).

<sup>62</sup> When using the SFA, a banking organization must meet minimum requirements under the Basel internal ratings-based approach to estimate probability of default and loss given default for the underlying exposures. Under the agencies' current risk-based capital rules, the SFA is available only



approach is referred to as the simplified supervisory formula approach (SSFA). Banking organizations may choose to use the alternative gross-up approach described in section II.5 below, provided that it applies the gross-up approach to all of its securitization exposures.

Similar to the SFA under the advanced approaches rule, the proposed SSFA is a formula that starts with a baseline derived from the capital requirements that apply to all exposures underlying a securitization and then assigns risk weights based on the subordination level of an exposure. The proposed SSFA was designed to apply relatively higher capital requirements to the more risky junior tranches of a securitization that are the first to absorb losses, and relatively lower requirements to the most senior exposures.

The SSFA methodology begins with “ $K_G$ ” the weighted-average risk weight of the underlying exposures, calculated using the risk-weighted asset amounts in the standardized approach of subpart D, as proposed in this NPR. In addition, the SSFA also uses the attachment and detachment points of the particular securitization positions, and the current amount of delinquencies within the

underlying exposures of the securitization. In terms of enhancements, the agencies note that the relative seniority of the exposure, as well as all cash funded enhancements, are recognized as part of the SSFA calculation.

The SSFA as proposed would apply a 1,250 percent risk weight to securitization exposures that absorb losses up to the amount of capital that would be required for the underlying exposures under subpart D had those exposures been held directly by a banking organization. In addition, agencies are proposing a supervisory risk-weight floor or minimum risk-weight for a given securitization of 20 percent. The agencies believe that a 20 percent floor is reasonably prudent given recent performance of securitization structures during times of stress, and will maintain this floor in the final rule.

At the inception of a securitization, the SSFA as proposed would require more capital on a transaction-wide basis than would be required if the pool of assets had not been securitized. That is, if the banking organization held every tranche of a securitization, its overall capital charge would be greater than if the banking organization held the

underlying assets in portfolio. The agencies believe this overall outcome is important in reducing the likelihood of regulatory capital arbitrage through securitizations.

To make the SSFA risk-sensitive and forward-looking, the agencies are proposing to adjust  $K_G$  based on delinquencies among the underlying assets of the securitization structure. Specifically, the parameter  $K_G$  is modified and the resulting adjusted parameter is labeled  $K_A$ .  $K_A$  is set equal to the weighted average of the  $K_G$  value and a fixed parameter equal to 0.5.

$$K_A = (1 - W) \cdot K_G + (W) \cdot 0.5$$

$K_G$  would be the weighted-average total capital requirement of the underlying exposures, calculated using the standardized risk weighting methodologies in subpart D, as proposed in this NPR. The agencies believe it is important to calibrate risk weights for securitization exposures around the risk associated with the underlying assets of the securitization in this proposal, in order to reduce complexity and promote consistency between the different frameworks for calculating risk-weighted asset amounts in the standardized approach.

In the proposal,  $K_G$  is expressed as a decimal value between zero and 1 (that is, an average risk weight of 100 percent means that  $K_G$  would equal 0.08). The variable  $W$  would equal the ratio of the sum of the dollar amounts of any underlying exposures within the securitized pool that are “delinquent” to the ending balance, measured in dollars, of underlying exposures. “Delinquent” would be defined as the sum of exposures that are 90 days or more past due, subject to a bankruptcy or insolvency proceeding, in the process of foreclosure, held as real estate owned, or are in default.

The agencies believe that, with the delinquent exposure calibration parameter set equal to 0.5, the overall capital requirement would be sufficiently responsive and prudent to

ensure sufficient capital for pools that demonstrate credit weakness. The entire specification of the SSFA in the final rule is as follows:

$$K_{SSFA} = \frac{ea_u - ea_l}{a(u - l)}$$

$K_{SSFA}$  is the risk based capital requirement for the securitization exposure and is a function of three variables, labeled  $a$ ,  $u$ , and  $l$ . The constant  $e$  is the base of the natural logarithms (which equals 2.71828). The variables  $a$ ,  $u$ , and  $l$  have the following definitions:

$$a = -\frac{1}{p \cdot K_A}$$

$$u = D - K_A$$

$$l = A - K_A$$

The values of  $A$  and  $D$  denote the attachment and detachment points, respectively, for the tranche. Specifically,  $A$  is the attachment point for the tranche that contains the securitization exposure and represents the threshold at which credit losses will first be allocated to the exposure. This input is the ratio, as expressed as a decimal value between zero and one, of the dollar amount of the securitization exposures that are subordinated to the tranche that contains the securitization exposure of the banking organization to the current dollar amount of all underlying exposures.  $D$  is the detachment point for the tranche that contains the securitization exposure and represents the threshold at which credit losses of principal allocated to the securitization exposure would result in a total loss of principal. This input, which is a decimal value between zero and one, equals the value of  $A$  plus the ratio of the dollar amount of the exposures and all pari passu exposures to the dollar amount of all underlying exposures. The SSFA specification is completed by the constant term  $p$ , which is set equal to 0.5 for securitization exposures that are not resecuritizations, or 1.5 for resecuritization exposures, and

the variable  $K_A$ , which is described above. The risk weight for the exposure (expressed as a percent) is equal to  $K_{SSFA}$  times 1,250.

When  $D$  for a securitization exposure is less than or equal to  $K_A$ , the exposure must be assigned a risk weight of 1,250 percent. When  $A$  for a securitization exposure is greater than or equal to  $K_A$ , the risk weight of the exposure, expressed as a percent, would equal  $K_{SSFA}$  times 1,250. When  $A$  is less than  $K_A$  and  $D$  is greater than  $K_A$ , the applicable risk weight is a weighted average of 1,250 percent and 1,250 percent times  $K_{SSFA}$ . The risk weight would be set according to the following formula:

$$RW = \left[ \left( \frac{K_A - A}{D - A} \right) \times 1,250 \text{ percent} \right] + \left[ \left( \frac{D - K_A}{D - A} \right) \times 1,250 \text{ percent} \times K_{SSFA} \right]$$

For resecuritizations, the agencies expect banking organizations to use the SSFA to measure that asset's contribution to  $K_G$ . For example, consider a hypothetical securitization tranche that has an attachment point at 0.06 and a detachment point at 0.07. Then assume that 90 percent of the underlying pool of assets of the resecuritization were mortgage loans that qualified for a 50 percent risk weight and that the remaining 10 percent of the pool was a single tranche of a prior securitization (where those underlying mortgages also qualified for a 50 percent weight), thus qualifying this as a resecuritization. Next, assume that the attachment point  $A$  of the securitization that is the 10 percent share of the resecuritization is 0.06 and the detachment point  $D$  is 0.08. Finally, assume that there are zero delinquent exposures in both the securitization and resecuritization pools.

The value of  $K_G$  for the resecuritization exposure would equal the weighted average of the two distinct  $K_G$  values. For the mortgages that qualify for the 50 percent risk weight and

represent 90 percent of the resecuritization,  $K_G$  equals 0.04 (i.e., 50 percent of the 8 percent risk-based capital standard).

$$K_{G, \text{re-securitization}} = (0.9 \cdot 0.04) + (0.1 \cdot K_{G, \text{securitization}})$$

To calculate the value of  $K_{G, \text{securitization}}$  a banking organization would use the attachment and detachment points of 0.06 and 0.08, respectively. Applying those input parameters to the SSFA (together with  $p = 0.5$  and  $K_G = 0.04$ ) results in a  $K_{G, \text{securitization}}$  equal to 0.2325.

Substituting this value into the equation yields:

$$K_{G, \text{re-securitization}} = (0.9 \cdot 0.04) + (0.1 \cdot 0.2325) = 0.05925$$

This value of 0.05925 for  $K_{G, \text{re-securitization}}$  would then be used in the calculation of the risk-based capital requirement for the tranche of the resecuritization (where  $A = 0.06$ ,  $B = 0.07$ , and  $p = 1.5$ ). The result is a risk weight of 1,172 percent for the tranche that runs from 0.06 to 0.07. Given that the attachment point is very close to the value of  $K_{G, \text{re-securitization}}$ , the capital charge is nearly equal to the maximum risk weight of 1,250 percent.

##### 5. Gross-up Approach

As an alternative to the SSFA, banking organizations that are not subject to subpart F may assign risk-based capital requirements to securitization exposures by implementing a gross-up approach described in section 43 of the proposal, which is similar to an approach provided under the general risk-based capital rules. If the banking organization chooses to apply the gross-up approach, it would be required to apply this approach to all of its securitization exposures, except as otherwise provided for certain securitization exposures under sections 44 and 45 of the proposal.

The gross-up approach assigns risk-based capital requirements based on the full amount of the credit-enhanced assets for which the banking organization directly or indirectly assumes credit risk. To calculate risk-weighted assets under the gross-up

approach, a banking organization would determine four inputs: the pro rata share, the exposure amount, the enhanced amount, and the applicable risk weight. The pro rata share is the par value of the banking organization's exposure as a percentage of the par value of the tranche in which the securitization exposure resides. The enhanced amount is the value of all the tranches that are more senior to the tranche in which the exposure resides. The applicable risk weight is the weighted-average risk weight of the underlying exposures in the securitization pool as calculated under subpart D.

Under the gross-up approach, a banking organization would be required to calculate the credit equivalent amount, which equals the sum of the exposure of the banking organization's securitization exposure and the pro rata share multiplied by the enhanced amount. To calculate risk-weighted

assets for a securitization exposure under the gross-up approach, a banking organization would be required to assign the applicable risk weight to the gross-up credit equivalent amount. As noted above, in all cases, the minimum risk weight for securitization exposures would be 20 percent.

*Question 18:* The agencies solicit commenters' views on the proposed gross-up approach.

##### 6. Alternative Treatments for Certain Types of Securitization Exposures

Under the NPR, a banking organization generally would assign a 1,250 percent risk weight to all securitization exposures to which the banking organization does not apply the SSFA or the gross-up approach. However, the NPR provides alternative treatments for certain types of securitization exposures described below, provided that the banking

organization knows the composition of the underlying exposures at all times:

a. Eligible ABCP Liquidity Facilities

In this NPR, consistent with the Basel capital framework, a banking organization would be permitted to determine the exposure amount of an eligible asset-backed commercial paper (ABCP) liquidity facility by multiplying the exposure amount by the highest risk weight applicable to any of the individual underlying exposures covered by the facility. The proposal would define an eligible ABCP liquidity facility to mean a liquidity facility supporting ABCP, in form or in substance, that is subject to an asset quality test at the time of draw that precludes funding against assets that are 90 days or more past due or in default. Notwithstanding the preceding sentence, a liquidity facility is an eligible ABCP liquidity facility if the assets or exposures funded under the liquidity facility that do not meet the eligibility requirements are guaranteed by a sovereign that qualifies for a 20 percent risk weight or lower.

b. A Securitization Exposures in a Second Loss Position or Better to an ABCP Program

Under the proposal, a banking organization may determine the risk-weighted asset amount of a securitization exposure that is in a second loss position or better to an ABCP program by multiplying the exposure amount by the higher of 100 percent and the highest risk weight applicable to any of the individual underlying exposures of the ABCP program,<sup>63</sup> provided the exposure meets the following criteria:

- (1) The exposure is not a first priority securitization exposure or an eligible ABCP liquidity facility;
- (2) The exposure is economically in a second loss position or better, and the first loss position provides significant credit protection to the second loss position;
- (3) The exposure qualifies as investment grade; and
- (4) The banking organization holding the exposure does not retain or provide protection for the first-loss position.

The agencies believe that this approach, which is consistent with the Basel capital framework, appropriately and conservatively assesses the credit risk of non-first-loss exposures to ABCP programs.

<sup>63</sup> The proposal would define an ABCP program as a program that primarily issues commercial paper that is investment grade and backed by underlying exposures held in a bankruptcy-remote manner.

7. Credit Risk Mitigation for Securitization Exposures

As proposed, the treatment of credit risk mitigation for securitization exposures would differ slightly from the treatment for other exposures. In general, to recognize the risk mitigating effects of financial collateral or an eligible guarantee or an eligible credit derivative from an eligible guarantor, a banking organization would use the approaches for collateralized transactions under section 37 of the proposal, the substitution treatment for guarantees and credit derivatives described in section 36 of the proposal.

Under section 45 of the proposal, a banking organization would be permitted to recognize an eligible guarantee or eligible credit derivative only from an eligible guarantor. In addition, when an eligible guarantee or eligible credit derivative covers multiple hedged exposures that have different residual maturities, the banking organization would be required to use the longest residual maturity of any of the hedged exposures as the residual maturity of all the hedged exposures.

8. Nth-to-default Credit Derivatives

The agencies propose that the capital requirement for protection provided through an nth-to-default derivative be determined either by using the SSFA, or applying a 1,250 percent risk weight. A banking organization would determine its exposure in the nth-to-default credit derivative as the largest notional amount of all the underlying exposures.

When applying the SSFA, the attachment point (parameter A) is the ratio of the sum of the notional amounts of all underlying exposures that are subordinated to the banking organization's exposure to the total notional amount of all underlying exposures. In the case of a first-to-default credit derivative, there are no underlying exposures that are subordinated to the banking organization's exposure. In the case of a second-or-subsequent-to default credit derivative, the smallest (n-1) underlying exposure(s) are subordinated to the banking organization's exposure.

Under the SSFA, the detachment point (parameter D) is the sum of the attachment point and the ratio of the notional amount of the banking organization's exposure to the total notional amount of the underlying exposures. A banking organization that does not use the SSFA to calculate a risk weight for an nth-to-default credit derivative would assign a risk weight of 1,250 percent to the exposure.

For protection purchased through a first-to-default derivative, a banking

organization that obtains credit protection on a group of underlying exposures through a first-to-default credit derivative that meets the rules of recognition for guarantees and credit derivatives under section 36(b) would determine its risk-based capital requirement for the underlying exposures as if the banking organization synthetically securitized the underlying exposure with the smallest risk-weighted asset amount and had obtained no credit risk mitigant on the other underlying exposures. A banking organization must calculate a risk-based capital requirement for counterparty credit risk according to section 34 for a first-to-default credit derivative that does not meet the rules of recognition of section 36(b).

For second-or-subsequent-to default credit derivatives, a banking organization that obtains credit protection on a group of underlying exposures through a nth-to-default credit derivative that meets the rules of recognition of section 36(b) (other than a first-to-default credit derivative) may recognize the credit risk mitigation benefits of the derivative only if the banking organization also has obtained credit protection on the same underlying exposures in the form of first-through-(n-1)-to-default credit derivatives; or if n-1 of the underlying exposures have already defaulted. If a banking organization satisfies these requirements, the banking organization would determine its risk-based capital requirement for the underlying exposures as if the banking organization had only synthetically securitized the underlying exposure with the smallest risk-weighted asset amount. For a nth-to-default credit derivative that does not meet the rules of recognition of section 36(b), a banking organization would calculate a risk-based capital requirement for counterparty credit risk according to the treatment of OTC derivatives under section 34.

I. Equity Exposures

1. Introduction

Under the general risk-based capital rules, a banking organization must deduct a portion of non-financial equity investments from tier 1 capital, based on the aggregate adjusted carrying value of all non-financial equity investments held directly or indirectly by the banking organization as a percentage of its tier 1 capital.<sup>64</sup> For those equity

<sup>64</sup> In contrast, the current rules for state and federal savings associations require the deduction of most equity securities from total capital. See 12 CFR part 167.5(c)(2)(ii) (federal savings

exposures that are not deducted, a banking organization generally must assign a 100 percent risk weight.

Consistent with the Basel capital framework, in this NPR, the agencies are proposing to require a banking organization to apply the simple risk-weight approach (SRWA) for equity exposures that are not exposures to an investment fund and apply certain look-through approaches to assign risk-weighted asset amounts to equity exposures to an investment fund. In some cases, such as equity exposures to the Federal Home Loan Bank, the treatment under the proposal would remain unchanged from the general risk-based capital rules. However, this NPR introduces changes to the treatment of equity exposures, which are consistent with the treatment for equity exposures under the advanced approaches rule, to improve risk sensitivity of the general risk-based capital requirements. For example, the proposal would differentiate between publicly-traded and non-publicly-traded equity exposures, while the general risk-based capital rules do not make such a distinction.

Under this NPR, the definition of equity exposure would include ownership interests that are residual claims on the assets and income of a company, unless the company is consolidated by the banking organization under GAAP, and options and warrants that would be equity exposures. The definition would exclude securitization exposures. Additionally, certain other criteria would need to be met for an exposure to be an “equity exposure,” as set forth in the proposed definition. See the definition of “equity exposure” in section 2 of the proposed rules in the related notice titled “Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum

Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action.”

2. Exposure Measurement

Under the proposal, a banking organization would be required to determine the adjusted carrying value for each equity exposure based on the approaches described below. For the on-balance sheet component of an equity exposure, the adjusted carrying value would be a banking organization’s carrying value of the exposure. For a commitment to acquire an equity exposure that is unconditional, the adjusted carrying value would be the effective notional principal amount of the exposure multiplied by a 100 percent conversion factor. For a commitment to acquire an equity exposure that is conditional, the adjusted carrying value would be the effective notional principal amount of the commitment multiplied by (1) a 20 percent conversion factor, for a commitment with an original maturity of one year or less or (2) a 50 percent conversion factor, for a commitment with an original maturity of over one year. For the off-balance sheet component of an equity exposure that is not an equity commitment, the adjusted carrying value would be the effective notional principal amount of the exposure, the size of which is equivalent to a hypothetical on-balance sheet position in the underlying equity instrument that would evidence the same change in fair value (measured in dollars) for a given small change in the price of the underlying equity instrument, minus the adjusted carrying value of the on-balance sheet component of the exposure.

As described in the hedged transactions section below, exposure amounts may have different treatments in the case of hedged equity exposures. The agencies created the concept of the

effective notional principal amount of the off-balance sheet portion of an equity exposure to provide a uniform method for banking organizations to measure the on-balance sheet equivalent of an off-balance sheet exposure. For example, if the value of a derivative contract referencing the common stock of company X changes the same amount as the value of 150 shares of common stock of company X, for a small change (for example, 1.0 percent) in the value of the common stock of company X, the effective notional principal amount of the derivative contract is the current value of 150 shares of common stock of company X, regardless of the number of shares the derivative contract references. The adjusted carrying value of the off-balance sheet component of the derivative is the current value of 150 shares of common stock of company X minus the adjusted carrying value of any on-balance sheet amount associated with the derivative.

3. Equity Exposure Risk Weights

Under the proposed SRWA, set forth in section 52 of the proposal, a banking organization would determine the risk-weighted asset amount for each equity exposure, other than an equity exposure to an investment fund, by multiplying the adjusted carrying value of the equity exposure, or the effective portion and ineffective portion of a hedge pair as described below, by the lowest applicable risk weight in table 9. A banking organization would determine the risk-weighted asset amount for an equity exposure to an investment fund under section 53 of the proposal. A banking organization would sum risk-weighted asset amounts for all of its equity exposures to calculate its aggregate risk-weighted asset amount for its equity exposures. The proposed SRWA is summarized in table 9 and described in more detail below:

TABLE 9—SIMPLE RISK-WEIGHT APPROACH (SRWA)

Risk weight (in percent)	Equity exposure
0 .....	An equity exposure to a sovereign, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, an MDB, and any other entity whose credit exposures receive a zero percent risk weight under section 32 of the proposal.
20 .....	An equity exposure to a PSE, Federal Home Loan Bank or the Federal Agricultural Mortgage Corporation (Farmer Mac).
100 .....	<ul style="list-style-type: none"> <li>• Community development equity exposures<sup>65</sup></li> <li>• The effective portion of a hedge pair</li> <li>• Non-significant equity exposures to the extent that the aggregate adjusted carrying value of the exposures does not exceed 10 percent of tier 1 capital plus tier 2 capital</li> </ul>
250 .....	A significant investment in the capital of an unconsolidated financial institution that is not deducted under section 22 of the proposal.

associations) and 12 CFR 390.465(c)(2)(ii) (state savings associations).

TABLE 9—SIMPLE RISK-WEIGHT APPROACH (SRWA)—Continued

Risk weight (in percent)	Equity exposure
300 .....	A publicly-traded equity exposure (other than an equity exposure that receives a 600 percent risk weight and including the ineffective portion of a hedge pair).
400 .....	An equity exposure that is not publicly-traded (other than an equity exposure that receives a 600 percent risk weight).
600 .....	An equity exposure to an investment firm that (i) would meet the definition of a traditional securitization were it not for the primary federal supervisor's application of paragraph (8) of that definition and (ii) has greater than immaterial leverage.

Under the proposal, equity exposures to sovereign, supranational entities, MDBs, and PSEs would receive a risk weight of zero percent, 20 percent, or 100 percent, as described in section 52 of the proposal. Certain community development equity exposures, the effective portion of hedged pairs, and, up to certain limits, non-significant equity exposures would receive a 100 percent risk weight. In addition, a banking organization generally would assign a 250 percent risk weight to an equity exposure related to a significant investment in the capital of unconsolidated financial institutions that is not deducted under section 22; a 300 percent risk weight to a publicly-traded equity exposure; and a 400 percent risk weight to a non-publicly-traded equity exposure.

This proposal defines publicly-traded as traded on: (1) any exchange registered with the SEC as a national securities exchange under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f); or (2) any non-U.S.-based securities exchange that is registered with, or approved by, a national securities regulatory authority and that provides a liquid, two-way market for the instrument in question. A two-way market would refer to a market where there are independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined within

<sup>65</sup> The proposed rule generally defines these exposures as exposures that would qualify as community development investments under 12 U.S.C. 24 (Eleventh), excluding equity exposures to an unconsolidated small business investment company and equity exposures held through a consolidated small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682). For savings associations, community development investments would be defined to mean equity investments that are designed primarily to promote community welfare, including the welfare of low- and moderate-income communities or families, such as by providing services or jobs, and excluding equity exposures to an unconsolidated small business investment company and equity exposures held through a consolidated small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682).

one day and settled at that price within a relatively short time frame conforming to trade custom.

The proposal would require banking organizations to assign a 600 percent risk weight to an equity exposure to an investment firm, provided that the investment firm (1) would meet the definition of a traditional securitization were it not for the primary federal supervisor's application of paragraph (8) of that definition and (2) has greater than immaterial leverage. As discussed in the securitizations section, the agencies would have discretion under this proposal to exclude from the definition of a traditional securitization those investment firms that exercise substantially unfettered control over the size and composition of their assets, liabilities, and off-balance sheet exposures. Equity exposures to investment firms that would otherwise be traditional securitizations were it not for the specific primary federal supervisor's exclusion are leveraged exposures to the underlying financial assets of the investment firm. The agencies believe that equity exposure to such firms with greater than immaterial leverage warrant a 600 percent risk weight under the SRWA, due to their particularly high risk. Moreover, the agencies believe that the 100 percent risk weight assigned to non-significant equity exposures is inappropriate for equity exposures to investment firms with greater than immaterial leverage.

#### 4. Non-significant Equity Exposures

Under this NPR, a banking organization would be permitted to apply a 100 percent risk weight to certain equity exposures deemed non-significant. Non-significant equity exposures would mean an equity exposure to the extent that the aggregate adjusted carrying value of the exposures does not exceed 10 percent of the banking organization's total capital.<sup>66</sup>

<sup>66</sup> The definition would exclude exposures to an investment firm that (1) would meet the definition of traditional securitization were it not for the primary federal supervisor's application of paragraph (8) of the definition of a traditional

To compute the aggregate adjusted carrying value of a banking organization's equity exposures for determining their non-significance, this proposal provides that the banking organization may exclude (1) Equity exposures that receive less than a 300 percent risk weight under the SRWA (other than equity exposures determined to be non-significant); (2) the equity exposure in a hedge pair with the smaller adjusted carrying value; and (3) a proportion of each equity exposure to an investment fund equal to the proportion of the assets of the investment fund that are not equity exposures or (4) exposures that qualify as community development equity exposures. If a banking organization does not know the actual holdings of the investment fund, the banking organization may calculate the proportion of the assets of the fund that are not equity exposures based on the terms of the prospectus, partnership agreement, or similar contract that defines the fund's permissible investments. If the sum of the investment limits for all exposure classes within the fund exceeds 100 percent, the banking organization would assume that the investment fund invests to the maximum extent possible in equity exposures.

To determine which of a banking organization's equity exposures qualify for a 100 percent risk weight based on non-significance, the banking organization first would include equity exposures to unconsolidated small business investment companies, or those held through consolidated small business investment companies described in section 302 of the Small Business Investment Act of 1958. Next, it would include publicly-traded equity exposures (including those held indirectly through investment funds), and then it would include non-publicly-traded equity exposures (including

securitization and (2) has greater than immaterial leverage.

those held indirectly through investment funds).<sup>67</sup>

The treatment of non-significant equity exposures in this proposal is consistent with the advanced approaches rule. However, in light of significant volatility in equity values since publication of the advanced approaches rule in 2007, and the BCBS revisions to the Basel capital framework, the agencies are considering whether a more simple treatment of banking organizations' non-significant equity exposures is appropriate.

One alternative would assign a 100 percent risk weight to a banking organization's equity exposures to small business investment companies and to stock that a banking organization acquires in satisfaction of debts previously contracted (DPC), consistent with the proposed treatment of community development investments and the effective portion of hedge pairs. The full amount of a banking organization's equity exposure to a small business investment company and the full amount of its DPC equity exposures (together with community development investments and the effective portion of hedge pairs) would receive a 100 percent risk weight, not just the "non-significant" portion of such equity exposures.

If the agencies assign a 100 percent risk weight to equity exposures to a small business investment company and to DPC equity exposures, the agencies would consider what other types of equity exposures, if any, would continue to be exempt from the calculation of the "non-significant" amount of equity exposures for risk-based capital purposes and what capital treatment would be appropriate for such exposures. For example, the agencies could reduce the threshold for non-significant equity exposure calculation from 10 percent of tier 1 capital and tier 2 capital to 5 percent of tier 1 and tier 2 capital.

*Question 19:* The agencies solicit comment on an alternative proposal to simplify the risk-based capital treatment of banking organizations' non-significant equity exposures by assigning a 100 percent risk weight to equity exposures to small business investment companies and to DPC equity exposures, consistent with the treatment of community development investments and the effective portion of hedged pairs. What other types of equity exposures (excluding exposures to small business investment companies and

equities taken for DPC) should be excluded from the non-significant equity exposure calculation under the alternative approach and what is the approximate amount of these exposures in relation to banking organizations' total capital? What would be an appropriate measure or level for determining whether equity exposures in the aggregate are "non-significant" for a banking organization?

#### 5. Hedged Transactions

In this NPR, the agencies are proposing the following treatment for recognizing hedged equity exposures. For purposes of determining risk-weighted assets under the SRWA, a banking organization could identify hedge pairs. Hedge pairs would be defined as two equity exposures that form an effective hedge, as long as each equity exposure is publicly-traded or has a return that is primarily based on a publicly-traded equity exposure. Under the NPR, a banking organization may risk weight only the effective and ineffective portions of a hedge pair rather than the entire adjusted carrying value of each exposure that makes up the pair.

Two equity exposures form an effective hedge if the exposures either have the same remaining maturity or each has a remaining maturity of at least three months; the hedge relationship is formally documented in a prospective manner (that is, before the banking organization acquires at least one of the equity exposures); the documentation specifies the measure of effectiveness (E) the banking organization would use for the hedge relationship throughout the life of the transaction; and the hedge relationship has an E greater than or equal to 0.8. A banking organization would measure E at least quarterly and would use one of three measures of E described in the next section: the dollar-offset method, the variability-reduction method, or the regression method.

It is possible that only part of a banking organization's exposure to a particular equity instrument is part of a hedge pair. For example, assume a banking organization has equity exposure A with a \$300 adjusted carrying value and chooses to hedge a portion of that exposure with equity exposure B with an adjusted carrying value of \$100. Also assume that the combination of equity exposure B and \$100 of the adjusted carrying value of equity exposure A form an effective hedge with an E of 0.8. In this situation,

the banking organization would treat \$100 of equity exposure A and \$100 of equity exposure B as a hedge pair, and the remaining \$200 of its equity exposure A as a separate, stand-alone equity position. The effective portion of a hedge pair would be calculated as E multiplied by the greater of the adjusted carrying values of the equity exposures forming the hedge pair. The ineffective portion of a hedge pair would be calculated as  $(1 - E)$  multiplied by the greater of the adjusted carrying values of the equity exposures forming the hedge pair. In the above example, the effective portion of the hedge pair would be  $0.8 \times \$100 = \$80$ , and the ineffective portion of the hedge pair would be  $(1 - 0.8) \times \$100 = \$20$ .

#### 6. Measures of Hedge Effectiveness

As stated above, a banking organization could determine effectiveness using any one of three methods: the dollar-offset method, the variability-reduction method, or the regression method. Under the dollar-offset method, a banking organization would determine the ratio of the cumulative sum of the changes in value of one equity exposure to the cumulative sum of the changes in value of the other equity exposure, termed the ratio of value change (RVC). If the changes in the values of the two exposures perfectly offset each other, the RVC would be  $-1$ . If RVC is positive, implying that the values of the two equity exposures move in the same direction, the hedge is not effective and E equals 0. If RVC is negative and greater than or equal to  $-1$  (that is, between zero and  $-1$ ), then E would equal the absolute value of RVC. If RVC is negative and less than  $-1$ , then E would equal 2 plus RVC.

The variability-reduction method of measuring effectiveness compares changes in the value of the combined position of the two equity exposures in the hedge pair (labeled X in the equation below) to changes in the value of one exposure as though that one exposure were not hedged (labeled A). This measure of E expresses the time-series variability in X as a proportion of the variability of A. As the variability described by the numerator becomes small relative to the variability described by the denominator, the measure of effectiveness improves, but is bounded from above by a value of one. E would be computed as:

<sup>67</sup> See 15 U.S.C. 682.



$$E = 1 - \frac{\sum_{t=1}^T (X_t - X_{t-1})^2}{\sum_{t=1}^T (A_t - A_{t-1})^2},$$

where

$$X_t = A_t - B_t,$$

$A_t$  = the value at time t of the one exposure in a hedge pair, and

$B_t$  = the value at time t of the other exposure in the hedge pair.

The value of t would range from zero to T, where T is the length of the observation period for the values of A and B, and is comprised of shorter values each labeled t.

The regression method of measuring effectiveness is based on a regression in which the change in value of one exposure in a hedge pair is the dependent variable and the change in value of the other exposure in the hedge pair is the independent variable. E would equal the coefficient of determination of this regression, which is the proportion of the variation in the dependent variable explained by variation in the independent variable. However, if the estimated regression coefficient is positive, then the value of E is zero. The closer the relationship between the values of the two exposures, the higher E would be.

#### 7. Equity Exposures to Investment Funds

Under the general risk-based capital rules, exposures to investment funds are captured through one of two methods. These methods are similar to the alternative modified look-through approach and the simple modified look-through approach described below. The agencies propose an additional option in this NPR, the full look-through approach.

The agencies propose a separate treatment for equity exposures to an investment fund to ensure that banking organizations do not receive a punitive risk-based capital requirement for equity exposures to investment funds that hold only low-risk assets, and to prevent banking organizations from arbitraging the proposed risk-based capital requirements for certain high-risk exposures.

As proposed, a banking organization would determine the risk-weighted asset amount for equity exposures to investment funds using one of three approaches: the full look-through

approach, the simple modified look-through approach, or the alternative modified look-through approach, unless the equity exposure to an investment fund is a community development equity exposure. Such community development equity exposures would be subject to a 100 percent risk weight. If an equity exposure to an investment fund is part of a hedge pair, a banking organization would use the ineffective portion of the hedge pair as the adjusted carrying value for the equity exposure to the investment fund. The risk-weighted asset amount of the effective portion of the hedge pair would be equal to its adjusted carrying value. A banking organization could choose which approach to apply for each equity exposure to an investment fund.

##### a. Full Look-through Approach

A banking organization may use the full look-through approach only if the banking organization is able to calculate a risk-weighted asset amount for each of the exposures held by the investment fund. Under the proposal, a banking organization would be required to calculate the risk-weighted asset amount for each of the exposures held by the investment fund (as calculated under subpart D of the proposal) as if the exposures were held directly by the banking organization. The banking organization's risk-weighted asset amount for the fund would be equal to the aggregate risk-weighted asset amount of the exposures held by the fund as if they were held directly by the banking organization multiplied by the banking organization's proportional ownership share of the fund.

##### b. Simple Modified Look-through Approach

Under the proposed simple modified look-through approach, a banking organization would set the risk-weighted asset amount for its equity exposure to an investment fund equal to

the adjusted carrying value of the equity exposure multiplied by the highest risk weight assigned according to subpart D of the proposal that applies to any exposure the fund is permitted to hold under the prospectus, partnership agreement, or similar agreement that defines the fund's permissible investments. The banking organization may exclude derivative contracts held by the fund that are used for hedging, rather than for speculative purposes, and do not constitute a material portion of the fund's exposures.

##### c. Alternative Modified Look-through Approach

Under the proposed alternative modified look-through approach, a banking organization may assign the adjusted carrying value of an equity exposure to an investment fund on a pro rata basis to different risk weight categories under subpart D of the proposal based on the investment limits in the fund's prospectus, partnership agreement, or similar contract that defines the fund's permissible investments.

The risk-weighted asset amount for the banking organization's equity exposure to the investment fund would be equal to the sum of each portion of the adjusted carrying value assigned to an exposure type multiplied by the applicable risk weight. If the sum of the investment limits for all exposures within the fund exceeds 100 percent, the banking organization would assume that the fund invests to the maximum extent permitted under its investment limits in the exposure type with the highest applicable risk weight under the proposed requirements and continues to make investments in the order of the exposure category with the next highest risk weight until the maximum total investment level is reached. If more than one exposure category applies to an exposure, the banking organization would use the highest applicable risk

weight. A banking organization may exclude derivative contracts held by the fund that are used for hedging, rather than for speculative purposes, and do not constitute a material portion of the fund's exposures.

### III. Insurance-related Activities

The agencies propose to apply consolidated capital requirements to savings and loan holding companies, consistent with the transfer of supervisory responsibilities to the Board under Title III of the Dodd-Frank Act, as well as the requirements in section 171 of the Dodd-Frank Act. Savings and loan holding companies have not been subject to consolidated quantitative capital requirements prior to this proposal.

In the Notice of Intent published in April 2011 (2011 notice of intent), the Board discussed the possibility of applying to savings and loan holding companies the same consolidated risk-based and leverage capital requirements as those proposed for bank holding companies.<sup>68</sup> The Board requested comment on unique characteristics, risks, or specific activities of savings and loan holding companies that should be taken into consideration when developing consolidated capital requirements for these entities. The Board also sought specific comment on instruments that are currently included in savings and loan holding companies' regulatory capital that would be excluded or strictly limited under Basel III, as well as the appropriate transition provisions.

The Board received comment letters on the 2011 notice of intent as well as on other notices issued in 2011 pertaining to savings and loan companies.<sup>69</sup> In addition, Board staff met with a number of industry participants, regulators, and trade groups to further the discussion of relevant considerations. The main themes raised by commenters relevant to this proposal were the appropriateness of requiring savings and loan holding companies to apply "bank-centric" consolidated capital standards; the need to appropriately address certain instruments and assets unique to savings and loan holding companies; the need for appropriate transition periods; and the degree of regulatory

burden (particularly for those savings and loan holding companies that are insurance companies that only prepare financial statements according to Statutory Accounting Principles).

A number of commenters suggested that the Board defer its oversight of savings and loan holding companies, in part or in whole, to functional regulators or impose the same capital standards required by insurance regulators. Other commenters suggested that certain savings and loan holding companies should be exempt from the Board's regulatory capital requirements in cases where depository institution activity constitutes only a small part of the consolidated organization's assets and revenues. The Board believes both of these approaches would be inconsistent with the requirements set out in section 171 of the Dodd-Frank Act. Further, the Board believes it is important to apply consolidated risk-based and leverage capital requirements to insurance-based holding companies because the insurance risk-based capital requirements are not imposed on a consolidated basis and are based on different considerations, such as solvency concerns, rather than broad categories of credit risk.

The Board considered all the comments received and believes that the proposed requirements for savings and loan holding companies appropriately take into consideration their unique characteristics, risks, and activities while ensuring compliance with the requirements of the Dodd-Frank Act. Further, a uniform approach for all holding companies would mitigate potential competitive equity issues, limit opportunities for regulatory arbitrage, and facilitate comparable treatment of similar risks.

In 2011, the agencies amended the general risk-based capital rules to provide that low-risk assets not held by depository institutions may receive the capital treatment applicable under the capital guidelines for bank holding companies under limited circumstances.<sup>70</sup> This provision provides appropriate capital requirements for certain low-risk exposures that generally are not held by depository institutions and brings the regulations applicable to bank holding companies into compliance with section 171 of the Dodd-Frank Act, which requires that bank holding companies be subject to capital requirements that are no less stringent than those applied to insured depository institutions. The

agencies propose to continue this approach for purposes of this NPR.

The proposed requirements that are unique to savings and loan holding companies or bank holding companies are discussed below, including provisions pertaining to the determination of risk-weighted assets for nonbanking exposures unique to insurance underwriting activities (whether conducted by a bank holding company or savings and loan holding company).

#### Policy Loans

A policy loan would be defined as a loan to policyholders under the provisions of an insurance contract that are secured by the cash surrender value or collateral assignment of the related policy or contract. A policy loan would include: (1) A cash loan, including a loan resulting from early payment or accelerated payment benefits, on an insurance contract when the terms of contract specify that the payment is a policy loan secured by the policy; and (2) an automatic premium loan, which is a loan made in accordance with policy provisions which provide that delinquent premium payments are automatically paid from the cash value at the end of the established grace period for premium payments.

Under the proposal, a policy loan would be assigned a 20 percent risk. Such treatment is similar to the treatment of a cash-secured loan. The Board believes this treatment is appropriate in light of the fact that should a borrower default, the resulting loss to the insurance company is mitigated by the right to access the cash surrender value or collateral assignment of the related policy.

#### Separate Accounts

A separate account is a legally segregated pool of assets owned and held by an insurance company and maintained separately from its general account assets for the benefit of an individual contract holder, subject to certain conditions. To qualify as a separate account, the following conditions generally must be met: (1) The account must be legally recognized under applicable law; (2) the assets in the account must be insulated from general liabilities of the insurance company under applicable law and protected from the insurance company's general creditors in the event of the insurer's insolvency; (3) the insurance company must invest the funds within the account as directed by the contract holder in designated investment alternatives or in accordance with specific investment objectives or

<sup>68</sup> See 76 FR 22662 (April 22, 2011).

<sup>69</sup> See, for example, "Agency Information Collection Activities Regarding Savings and Loan Holding Companies," available at <http://www.gpo.gov/fdsys/pkg/FR-2011-12-29/pdf/2011-33432.pdf>; "Proposed Agency Information Collection Activities; Comment Request," available at <http://www.gpo.gov/fdsys/pkg/FR-2011-08-25/pdf/2011-21736.pdf>.

<sup>70</sup> See 76 FR 37620 (June 28, 2011).

policies; and (4) all investment performance, net of contract fees and assessments, must be passed through to the contract holder, provided that contracts may specify conditions under which there may be a minimum guarantee, but not a ceiling.

Under the general risk-based capital rules, assets held in separate accounts are assigned to risk-weight categories based on the risk weight of the underlying assets. However, the agencies propose to assign a zero percent risk weight to assets held in non-guaranteed separate accounts where all the losses are passed on to the contract holders. To qualify as a non-guaranteed separate account, the insurance company could not contractually guarantee a minimum return or account value to the contract holder, and the insurance company would not be required to hold reserves for these separate account assets pursuant to its contractual obligations on an associated policy. The proposal would maintain the current risk-weighting treatment for assets held in a separate account that does not qualify as a non-guaranteed separate account.

The agencies believe the proposed treatment for non-guaranteed separate account assets is appropriate, even though the proposed definition of non-guaranteed separate accounts is more restrictive than the one used by insurance regulators. The proposed criteria for non-guaranteed separate accounts are designed to ensure that a zero percent risk weight is applied only to the assets for which contract holders, and not an insurance company, would bear all the losses.

*Question 20:* The agencies request comment on how the proposed definition of a separate account interacts with state law. What are the significant differences and what is the nature of the implications of these differences?

#### Deferred Acquisition Costs and Value of Business Acquired

Deferred acquisition costs (DAC) represent certain costs incurred in the acquisition of a new contract or renewal insurance contract that are capitalized pursuant to GAAP. Value of business acquired (VOBA) refers to assets that reflect revenue streams from insurance policies purchased by an insurance company. The Board proposes to risk weight these assets at 100 percent, similar to other assets not specifically assigned a different risk weight under this NPR.

#### Surplus Notes

A surplus note is a financial instrument issued by an insurance

company that is included in surplus for statutory accounting purposes as prescribed or permitted by state laws and regulations. A surplus note generally has the following features: (1) The applicable state insurance regulator approves in advance the form and content of the note; (2) the instrument is subordinated to policyholders, to claimant and beneficiary claims, and to all other classes of creditors other than surplus note holders; and (3) the applicable state insurance regulator is required to approve in advance any interest payments and principal repayments on the instrument.

The Board believes that surplus notes do not meet the proposal's eligibility criteria for tier 1 capital. In particular, surplus notes are not perpetual instruments but represent debt instruments that are treated as equity for insurance regulatory capital purposes. Surplus notes are long-term, unsecured obligations, subordinated to all senior debt holders and policy claims. The main equity characteristics of surplus notes are the loss absorbency feature and the need to obtain prior approval from insurance regulators before issuance.

Some commenters on the Board's savings and loan holding company-related proposals issued in 2011 recommended that all outstanding surplus note issuances should be grandfathered and considered eligible as additional tier 1 capital instruments. Other commenters believed the Basel III framework provided sufficient flexibility to include surplus notes in tier 1 capital given the BCBS's recognition that Basel III should accommodate the specific needs of non-joint stock companies, such as mutual and cooperatives, which are unable to issue common stock. The Board believes generally that including surplus notes in tier 1 capital would be inconsistent with the proposed eligibility criteria for regulatory capital instruments and with overall safety and soundness concerns because surplus notes generally do not reflect the required loss absorbency characteristics of tier 1 instruments under the proposal. A surplus note could be eligible for inclusion in tier 2 capital provided the note meets the proposed tier 2 capital eligibility criteria. The Board has sought to incorporate reasonable transition provisions in the first NPR for instruments that would no longer meet the eligibility criteria for tier 2 capital.

#### Additional Deductions—Insurance Underwriting Subsidiaries

Consistent with the current treatment under the advanced approaches rule,

the Basel III NPR would require bank holding companies and savings and loan holding companies to consolidate and deduct the minimum regulatory capital requirement of insurance underwriting subsidiaries (generally 200 percent of the subsidiary's authorized control level as established by the appropriate state insurance regulator) from total capital to reflect the capital needed to cover insurance risks. The proposed deduction treatment recognizes that capital requirements imposed by the functional regulator to cover the various risks that insurance risk-based capital captures reflect capital needs at the particular subsidiary and that this capital is therefore not generally available to absorb losses in other parts of the organization. The deduction would be 50 percent from tier 1 capital and 50 percent from tier 2 capital.

*Question 21:* The agencies solicit comment on all aspects of the proposed treatment of insurance underwriting activities.

*Question 22:* What are the specific terms and features of capital instruments (including surplus notes) unique to insurance companies that diverge from current eligibility requirements under the proposal? Are there ways in which such terms and features might be modified in order to bring the instruments into compliance with the proposal?

*Question 23:* The agencies seek data on the amount and issuers of surplus notes currently outstanding. What proportion of insurance company capital is comprised of surplus notes?

## IV. Market Discipline and Disclosure Requirements

### A. Proposed Disclosure Requirements

The agencies have long supported meaningful public disclosure by banking organizations with the objective of improving market discipline and encouraging sound risk-management practices. As noted above, the BCBS introduced public disclosure requirements under Pillar 3 of Basel II, which is designed to complement the minimum capital requirements and the supervisory review process by encouraging market discipline through enhanced and meaningful public disclosure.<sup>71</sup> The BCBS introduced additional disclosure requirements in Basel III, which the agencies are

<sup>71</sup> The agencies incorporated the BCBS disclosure requirements into the advanced approaches rule in 2007. See 72 FR 69288, 69432 (December 7, 2007).

proposing to apply to banking organizations as discussed herein.<sup>72</sup>

The public disclosure requirements under this NPR would apply only to banking organizations representing the top consolidated level of the banking group with \$50 billion or more in total consolidated assets that are not advanced approaches banking organizations making public disclosures pursuant to section 172 of the proposal.<sup>73</sup> The agencies note that the asset threshold of \$50 billion is consistent with the threshold established by section 165 of the Dodd-Frank Act relating to enhanced supervision and prudential standards for certain banking organizations.<sup>74</sup> In addition, the agencies are trying to strike an appropriate balance between the market benefits of disclosure and the additional burden to a banking organization that provides disclosures. A banking organization may be able to fulfill some of the proposed disclosure requirements by relying on similar disclosures made in accordance with accounting standards or SEC mandates. In addition, a banking organization could use information provided in regulatory reports to fulfill the disclosure requirements. In these situations, a banking organization would be required to explain any material differences between the accounting or other disclosures and the disclosures required under this proposal.

A banking organization's exposure to risks and the techniques that it uses to identify, measure, monitor, and control those risks are important factors that market participants consider in their assessment of the banking organization. Accordingly, as proposed, a banking organization would have a formal disclosure policy approved by its board of directors that addresses the banking organization's approach for determining the disclosures it should make. The

policy should address the associated internal controls, disclosure controls, and procedures. The board of directors and senior management would ensure the appropriate review of the disclosures and that effective internal controls, disclosure controls, and procedures are maintained. One or more senior officers of the banking organization must attest that the disclosures meet the requirements of this proposal.

A banking organization would decide the relevant disclosures based on a materiality concept. Information would be regarded as material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information for the purpose of making investment decisions.

#### *B. Frequency of Disclosures*

Consistent with the agencies' longstanding requirements for robust quarterly disclosures in regulatory reports, and considering the potential for rapid changes in risk profiles, this NPR would require that quantitative disclosures are made quarterly. However, qualitative disclosures that provide a general summary of a banking organization's risk-management objectives and policies, reporting system, and definitions may be disclosed annually, provided any significant changes are disclosed in the interim.

The proposal would require that the disclosures are timely. The agencies acknowledge that the timing of disclosures under the federal banking laws may not always coincide with the timing of disclosures required under other federal laws, including disclosures required under the federal securities laws and their implementing regulations by the SEC. For calendar quarters that do not correspond to fiscal year-end, the agencies would consider those disclosures that are made within 45 days as timely. In general, where a banking organization's fiscal year end coincides with the end of a calendar quarter, the agencies would consider disclosures to be timely if they are made no later than the applicable SEC disclosure deadline for the corresponding Form 10-K annual report. In cases where an institution's fiscal year-end does not coincide with the end of a calendar quarter, the primary federal supervisor would consider the timeliness of disclosures on a case-by-case basis. In some cases, management may determine that a significant change has occurred, such that the most recent reported amounts do not reflect the banking organization's

capital adequacy and risk profile. In those cases, a banking organization would need to disclose the general nature of these changes and briefly describe how they are likely to affect public disclosures going forward. A banking organization would make these interim disclosures as soon as practicable after the determination that a significant change has occurred.

#### *C. Location of Disclosures and Audit Requirements*

The disclosures required by the proposal would have to be publicly available (for example, included on a public Web site) for each of the last three years or such shorter time period beginning when the proposal comes into effect. Except as discussed below, management would have some discretion to determine the appropriate medium and location of the disclosure. Furthermore, a banking organization would have flexibility in formatting its public disclosures.

The agencies encourage management to provide all of the required disclosures in one place on the entity's public Web site and the agencies anticipate that the public Web site address would be reported in a banking organization's regulatory report. Alternatively, banking organizations would be permitted to provide the disclosures in more than one place, as some of them may be included in public financial reports (for example, in Management's Discussion and Analysis included in SEC filings) or other regulatory reports. The agencies would encourage such banking organizations to provide a summary table on their public Web site that specifically indicates where all the disclosures may be found (for example, regulatory report schedules, page numbers in annual reports).

Disclosures of common equity tier 1, tier 1, and total capital ratios would be tested by external auditors as part of the financial statement audit. Disclosures that are not included in the footnotes to the audited financial statements are not subject to external audit reports for financial statements or internal control reports from management and the external auditor.

#### *D. Proprietary and Confidential Information*

The agencies believe that the proposed requirements strike an appropriate balance between the need for meaningful disclosure and the protection of proprietary and confidential information.<sup>75</sup> Accordingly,

<sup>75</sup> Proprietary information encompasses information that, if shared with competitors, would

<sup>72</sup> In December 2011, the BCBS proposed additional Pillar 3 disclosure requirements in a consultative paper titled "Definition of Capital Disclosure Requirements," available at <http://www.bis.org/publ/bcbs212.pdf>. The agencies anticipate incorporating these disclosure requirements for banking organizations with more than \$50 billion in total assets through a separate rulemaking once the BCBS finalizes these disclosure requirements.

<sup>73</sup> Advanced approaches banking organizations would be subject to the disclosure requirements described in the Advanced Approaches and Market Risk NPR.

<sup>74</sup> See section 165(a) of the Dodd-Frank Act (12 U.S.C. 5365(a)). The Dodd-Frank Act provides that the Board may, upon the recommendation of the Financial Stability Oversight Council, increase the \$50 billion asset threshold for the application of the resolution plan, concentration limit, and credit exposure report requirements. See 12 U.S.C. 5365(a)(2)(B).

the agencies believe that banking organizations would be able to provide all of these disclosures without revealing proprietary and confidential information. Only in rare circumstances might disclosure of certain items of information required by the proposal compel a banking organization to reveal confidential and proprietary information. In these unusual situations, the agencies propose that if a banking organization believes that disclosure of specific commercial or financial information would compromise its position by making public information that is either proprietary or confidential in nature, the banking organization need not disclose those specific items. Instead, the banking organization must disclose more general information about the subject matter of the requirement, together with the fact that, and the reason why, the specific items of information have not been disclosed. This provision would apply only to those disclosures included in this NPR and does not apply to disclosure requirements imposed by accounting standards or other regulatory agencies.

*Question 24:* The agencies seek commenters' views on all of the elements of the proposed public disclosure requirements. In particular, the agencies seek views on specific disclosure requirements that are problematic, and why.

#### *E. Specific Public Disclosure Requirements*

The public disclosure requirements are designed to provide important information to market participants on the scope of application, capital, risk exposures, risk assessment processes, and, thus, the capital adequacy of the institution. The agencies note that the substantive content of the tables is the focus of the disclosure requirements, not the tables themselves. The table numbers below refer to the table numbers in the proposal.

A banking organization would make the disclosures described in tables 14.1 through 14.10. The banking organization would make these disclosures publicly available for each of the last three years or such shorter time period beginning when the proposed requirements come into effect.<sup>76</sup>

render a banking organization's investment in these products/systems less valuable, and, hence, could undermine its competitive position. Information about customers is often confidential, in that it is provided under the terms of a legal agreement or counterparty relationship.

<sup>76</sup>Other public disclosure requirements would continue to apply, such as federal securities law, and regulatory reporting requirements for banking organizations.

Table 14.1 disclosures, "Scope of Application," would name the top corporate entity in the group to which subpart D of the proposal would apply; include a brief description of the differences in the basis for consolidating entities for accounting and regulatory purposes, as well as a description of any restrictions, or other major impediments, on transfer of funds or total capital within the group. These disclosures provide the basic context underlying regulatory capital calculations.

Table 14.2 disclosures, "Capital Structure," would provide summary information on the terms and conditions of the main features of regulatory capital instruments, which would allow for an evaluation of the quality of the capital available to absorb losses within a banking organization. A banking organization also would disclose the total amount of common equity tier 1, tier 1 and total capital, with separate disclosures for deductions and adjustments to capital. The agencies expect that many of these disclosure requirements would be captured in revised regulatory reports.

Table 14.3 disclosures, "Capital Adequacy," would provide information on a banking organization's approach for categorizing and risk-weighting its exposures, as well as the amount of total risk-weighted assets. The table would also include common equity tier 1, and tier 1 and total risk-based capital ratios for the top consolidated group; and for each depository institution subsidiary.

Table 14.4 disclosures, "Capital Conservation Buffer," would require a banking organization to disclose the capital conservation buffer, the eligible retained income and any limitations on capital distributions and certain discretionary bonus payments, as applicable.

Tables 14.5, 14.6 and 14.7 disclosures, related to credit risk, counterparty credit risk and credit risk mitigation, respectively, would provide market participants with insight into different types and concentrations of credit risk to which a banking organization is exposed and the techniques it uses to measure, monitor, and mitigate those risks. These disclosures are intended to enable market participants to assess the credit risk exposures of the banking organization without revealing proprietary information.

Table 14.8 disclosures, "Securitization," would provide information to market participants on the amount of credit risk transferred and retained by a banking organization through securitization transactions, the types of products securitized by the

organization, the risks inherent in the organization's securitized assets, the organization's policies regarding credit risk mitigation, and the names of any entities that provide external credit assessments of a securitization. These disclosures would provide a better understanding of how securitization transactions impact the credit risk of a bank. For purposes of these disclosures, "exposures securitized" include underlying exposures originated by a banking organization, whether generated by the banking organization or purchased from third parties, and third-party exposures included in sponsored programs. Securitization transactions in which the originating banking organization does not retain any securitization exposure would be shown separately and would only be reported for the year of inception.

Table 14.9 disclosures, "Equities Not Subject to Subpart F of the [proposal]," would provide market participants with an understanding of the types of equity securities held by the banking organization and how they are valued. The table would also provide information on the capital allocated to different equity products and the amount of unrealized gains and losses.

Table 14.10 disclosures, "Interest Rate Risk for Non-trading Activities," would require banking organization to provide certain quantitative and qualitative disclosures regarding the banking organization's management of interest rate risks.

#### **V. List of Acronyms That Appear in the Proposal**

ABCP	Asset-Backed Commercial Paper
ABS	Asset Backed Security
ADC	Acquisition, Development, or Construction
AFS	Available For Sale
ALLL	Allowance for Loan and Lease Losses
AOCI	Accumulated Other Comprehensive Income
BCBS	Basel Committee on Banking Supervision
BHC	Bank Holding Company
BIS	Bank for International Settlements
CAMELS	Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk
CCF	Credit Conversion Factor
CCP	Central Counterparty
CDC	Community Development Corporation
CDFI	Community Development Financial Institution
CDO	Collateralized Debt Obligation
CDS	Credit Default Swap
CDSind	Index Credit Default Swap
CEIO	Credit-Enhancing Interest-Only Strip
CF	Conversion Factor
CFR	Code of Federal Regulations
CFTC	Commodity Futures Trading Commission
CMBS	Commercial Mortgage Backed Security

CPSS Committee on Payment and Settlement Systems  
 CRC Country Risk Classifications  
 CRAM Country Risk Assessment Model  
 CRM Credit Risk Mitigation  
 CUSIP Committee on Uniform Securities Identification Procedures  
 DAC Deferred Acquisition Costs  
 DCO Derivatives Clearing Organizations  
 DFA Dodd-Frank Act  
 DI Depository Institution  
 DPC Debts Previously Contracted  
 DTA Deferred Tax Asset  
 DTL Deferred Tax Liability  
 DVA Debit Valuation Adjustment  
 DvP Delivery-versus-Payment  
 E Measure of Effectiveness  
 EAD Exposure at Default  
 ECL Expected Credit Loss  
 EE Expected Exposure  
 E.O. Executive Order  
 EPE Expected Positive Exposure  
 FASB Financial Accounting Standards Board  
 FDIC Federal Deposit Insurance Corporation  
 FFIEC Federal Financial Institutions Examination Council  
 FHLMC Federal Home Loan Mortgage Corporation  
 FMU Financial Market Utility  
 FNMA Federal National Mortgage Association  
 FR **Federal Register**  
 GAAP Generally Accepted Accounting Principles  
 GDP Gross Domestic Product  
 GLBA Gramm-Leach-Bliley Act  
 GSE Government-Sponsored Entity  
 HAMP Home Affordable Mortgage Program  
 HELOC Home Equity Line of Credit  
 HOLA Home Owners' Loan Act  
 HVCRE High-Volatility Commercial Real Estate  
 IAA Internal Assessment Approach  
 IFRS International Reporting Standards  
 IMM Internal Models Methodology  
 I/O Interest-Only  
 IOSCO International Organization of Securities Commissions  
 LTV Loan-to-Value Ratio  
 M Effective Maturity  
 MDB Multilateral Development Banks  
 MSA Mortgage Servicing Assets  
 NGR Net-to-Gross Ratio  
 NPR Notice of Proposed Rulemaking  
 NRSRO Nationally Recognized Statistical Rating Organization  
 OCC Office of the Comptroller of the Currency  
 OECD Organization for Economic Cooperation and Development  
 OIRA Office of Information and Regulatory Affairs  
 OMB Office of Management and Budget  
 OTC Over-the-Counter  
 OTTI Other Than Temporary Impairment  
 PCA Prompt Corrective Action  
 PCCR Purchased Credit Card Relationships  
 PFE Potential Future Exposure  
 PMI Private Mortgage Insurance  
 PSE Public Sector Entities  
 PVP Payment-versus-payment  
 QCCP Qualifying Central Counterparty  
 REIT Real Estate Investment Trust  
 RFA Regulatory Flexibility Act

RMBS Residential Mortgage Backed Security  
 RTCRRI Act Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991  
 RVC Ratio of Value Change  
 RWA Risk-Weighted Asset  
 SEC Securities and Exchange Commission  
 SFA Supervisory Formula Approach  
 SFT Securities Financing Transactions  
 SLHC Savings and Loan Holding Company  
 SPE Special Purpose Entity  
 SPV Special Purpose Vehicle  
 SR Supervision and Regulation Letter  
 SRWA Simple Risk-Weight Approach  
 SSFA Simplified Supervisory Formula Approach  
 UMRA Unfunded Mandates Reform Act of 1995  
 U.S. United States  
 U.S.C. United States Code  
 VaR Value-at-Risk  
 VOBA Value of Business Acquired

## VI. Regulatory Flexibility Act

The Regulatory Flexibility Act, 5 U.S.C. 601 *et seq.* (RFA) requires an agency to provide an initial regulatory flexibility analysis with a proposed rule or to certify that the rule will not have a significant economic impact on a substantial number of small entities (defined for purposes of the RFA to include banking entities with assets less than or equal to \$175 million) and publish its certification and a short, explanatory statement in the **Federal Register** along with the proposed rule.

The agencies are separately publishing initial regulatory flexibility analyses for the proposals as set forth in this NPR.

### Board

#### A. Statement of the Objectives of the Proposal; Legal Basis

As discussed in the Supplementary Information above, the Board is proposing to revise its capital requirements to promote safe and sound banking practices, implement Basel III and other aspects of the Basel capital framework, and codify its capital requirements.

The proposals in this NPR and the Basel III NPR would implement provisions consistent with certain requirements of the Dodd-Frank Act because they would (1) revise regulatory capital requirements to remove all references to, and requirements of reliance on, credit ratings,<sup>77</sup> and (2) impose new or revised minimum capital requirements on certain depository institution holding companies.<sup>78</sup>

Additionally, under section 38(c)(1) of the Federal Deposit Insurance Act, the agencies may prescribe capital

standards for depository institutions that they regulate.<sup>79</sup> In addition, among other authorities, the Board may establish capital requirements for state member banks under the Federal Reserve Act,<sup>80</sup> for state member banks and bank holding companies under the International Lending Supervision Act and Bank Holding Company Act,<sup>81</sup> and for savings and loan holding companies under the Home Owners Loan Act.<sup>82</sup>

#### B. Small Entities Potentially Affected by the Proposal

Under regulations issued by the Small Business Administration,<sup>83</sup> a small entity includes a depository institution, bank holding company, or savings and loan holding company with total assets of \$175 million or less (a small banking organization). As of March 31, 2012 there were 373 small state member banks. As of December 31, 2011, there were approximately 128 small savings and loan holding companies and 2,385 small bank holding companies.<sup>84</sup>

The proposed requirements would not apply to small bank holding companies that are not engaged in significant nonbanking activities, do not conduct significant off-balance sheet activities, and do not have a material amount of debt or equity securities outstanding that are registered with the SEC. These small bank holding companies remain subject to the Board's Small Bank Holding Company Policy Statement (Policy Statement).<sup>85</sup>

Small state member banks and small savings and loan holding companies (covered small banking organizations) would be subject to the proposals in this NPR.

#### C. Impact on Covered Small Banking Organizations

The proposed requirements in the Basel III NPR and this NPR may impact covered small banking organizations in several ways, including both recordkeeping and compliance requirements. As explained in the Basel III NPR, the proposals therein would change the minimum capital ratios and

<sup>79</sup> See 12 U.S.C. 1831o(c).

<sup>80</sup> See 12 U.S.C. 321–338.

<sup>81</sup> See 12 U.S.C. 3907; 12 U.S.C. 1844.

<sup>82</sup> See 12 U.S.C. 1467a(g)(1).

<sup>83</sup> See 13 CFR 121.201.

<sup>84</sup> The December 31, 2011 data are the most recent available data on small savings and loan holding companies and small bank holding companies.

<sup>85</sup> See 12 CFR part 225, appendix C. Section 171 of the Dodd-Frank provides an exemption from its requirements for bank holding companies subject to the Policy Statement (as in effect on May 19, 2010). Section 171 does not provide a similar exemption for small savings and loan holding companies and they are therefore subject to the proposed rules. 12 U.S.C. 5371(b)(5)(C).

<sup>77</sup> See 15 U.S.C. 78o–7, note.

<sup>78</sup> See 12 U.S.C. 5371.

qualifying criteria for regulatory capital, including required deductions and adjustments. The proposals in this NPR would modify the risk weight treatment for some exposures.

Most small state member banks already hold capital in excess of the proposed minimum risk-based regulatory ratios. Therefore, the proposed requirements are not expected to significantly impact the capital structure of most covered small state member banks. Comparing the capital requirements proposed in this NPR and the Basel III NPR on a fully phased-in basis to minimum requirements of the current rules, the capital ratios of approximately 1–2 percent of small state member banks would fall below at least one of the proposed minimum risk-based capital requirements. Thus, the Board believes that the proposals in this NPR and the Basel III NPR would affect an insubstantial number of small state member banks.

Because the Board has not fully implemented reporting requirements for savings and loan holding companies, it is unable to determine the impact of the proposed requirements on small savings and loan holding companies. The Board seeks comment on the potential impact of the proposed requirements on small savings and loan holding companies.

Covered small banking organizations that would have to raise additional capital to comply with the requirements of the proposal may incur certain costs, including costs associated with issuance of regulatory capital instruments. The Board has sought to minimize the burden of raising additional capital by providing for transitional arrangements that phase-in the new capital requirements over several years, allowing banking organizations time to accumulate additional capital through retained earnings as well as raising capital in the market.

As discussed above, the proposed requirements would modify risk weights for exposures, as well as calculation of the leverage ratio. Accordingly, covered small banking organizations would be required to change their internal reporting processes to comply with these changes. These changes may require some additional personnel training and expenses related to new systems (or modification of existing systems) for calculating regulatory capital ratios.

Additionally, covered small banking organizations that hold certain exposures would be required to obtain additional information under the proposed rules in order to determine the applicable risk weights. Covered small banking organizations that hold

exposures to sovereign entities other than the United States, foreign depository institutions, or foreign public sector entities would have to acquire Country Risk Classification ratings produced by the OECD to determine the applicable risk weights. Covered small banking organizations that hold residential mortgage exposures would need to have and maintain information about certain underwriting features of the mortgage as well as the LTV ratio in order to determine the applicable risk weight. Generally, covered small banking organizations that hold securitization exposures would need to obtain sufficient information about the underlying exposures to satisfy due diligence requirements and apply the simplified supervisory formula described above to calculate the appropriate risk weight, or be required to assign a 1,250 percent risk weight to the exposure.

Covered small banking organizations typically do not hold significant exposures to foreign entities or securitization exposures, and the Board expects any additional burden related to calculating risk weights for these exposures, or holding capital against these exposures, would be modest. Some covered small banking organizations may hold significant residential mortgage exposures. However, if the small banking organization originated the exposure, it should have sufficient information to determine the applicable risk weight under the proposal. If the small banking organization acquired the exposure from another institution, the information it would need to determine the applicable risk weight is consistent with information that it should normally collect for portfolio monitoring purposes and internal risk management.

Covered small banking organizations would not be subject to the disclosure requirements in subpart D of the proposal. However, the Board expects to modify regulatory reporting requirements that apply to covered small banking organizations to reflect the changes made to the Board's capital requirements in the proposal. The Board expects to propose these changes to the relevant reporting forms in a separate notice.

For small savings and loan holding companies, the compliance burdens described above may be greater than for those of other covered small banking organizations. Small savings and loan holding companies previously were not subject to regulatory capital requirements and reporting requirements tied regulatory capital requirements. Small savings and loan

holding companies may therefore need to invest additional resources in establishing internal systems (including purchasing software or hiring personnel) or raising capital to come into compliance with the proposed rules.

#### D. Transitional Arrangements To Ease Compliance Burden

For those covered small banking organizations that would not immediately meet the proposed minimum requirements, the NPR provides transitional arrangements for banking organizations to make adjustments and to come into compliance. Small covered banking organizations would be required to meet the proposed minimum capital ratio requirements beginning on January 1, 2013 through to December 31, 2014. On January 1, 2015, small covered banking organizations would be required to comply with the new Prompt Corrective Action capital ratio requirements proposed in the Basel III NPR. January 1, 2015 is also the proposed effective date for small covered companies to begin calculating risk-weighted assets according to the methodologies in this NPR.

#### E. Identification of Duplicative, Overlapping, or Conflicting Federal Rules

The Board is unaware of any duplicative, overlapping, or conflicting federal rules. As noted above, the Board anticipates issuing a separate proposal to implement reporting requirements that are tied to (but do not overlap or duplicate) the requirements of the proposed rules. The Board seeks comments and information regarding any such rules that are duplicative, overlapping, or otherwise in conflict with the proposed rules.

#### F. Discussion of Significant Alternatives

The Board has sought to incorporate flexibility into the proposals in this NPR and provide alternative treatments to lessen burden and complexity for smaller banking organizations wherever possible, consistent with safety and soundness and applicable law, including the Dodd-Frank Act. These alternatives and flexibility features include the following:

- Covered small banking organizations would not be subject to the enhanced disclosure requirements of the proposed rules.
- Covered small banking organizations could choose to apply the gross-up approach for securitization exposures rather than the SSFA.



The proposal also offers covered small banking organizations a choice between a simpler and more complex methods of risk weighting equity exposures to investment funds.

The Board welcomes comment on any significant alternatives to the proposed rules applicable to covered small banking organizations that would minimize their impact on those entities, as well as on all other aspects of its analysis. A final regulatory flexibility analysis will be conducted after consideration of comments received during the public comment period.

#### OCC

In accordance with section 3(a) of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) (RFA), the OCC is publishing this summary of its Initial Regulatory Flexibility Analysis (IRFA) for this NPR. The RFA requires an agency to publish in the **Federal Register** its IRFA or a summary of its IRFA at the time of the publication of its general notice of proposed rulemaking<sup>86</sup> or to certify that the proposed rule will not have a significant economic impact on a substantial number of small entities.<sup>87</sup> For its IRFA, the OCC analyzed the potential economic impact of this NPR on the small entities that it regulates.

The OCC welcomes comment on all aspects of the summary of its IRFA. A final regulatory flexibility analysis will be conducted after consideration of comments received during the public comment period.

#### A. Reasons Why the Proposed Rule is Being Considered by the Agencies; Statement of the Objectives of the Proposed Rule; and Legal Basis

As discussed in the Supplementary Information section above, the agencies are proposing to revise their capital requirements to promote safe and sound banking practices, implement Basel III, and harmonize capital requirements across charter type. This NPR also satisfies certain requirements under the Dodd-Frank Act by revising regulatory capital requirements to remove all references to, and requirements of reliance on, credit ratings. Federal law authorizes each of the agencies to prescribe capital standards for the banking organizations it regulates.<sup>88</sup>

#### B. Small Entities Affected by the Proposal

Under regulations issued by the Small Business Administration,<sup>89</sup> a small entity includes a depository institution or bank holding company with total assets of \$175 million or less (a small banking organization). As of March 31, 2012, there were approximately 599 small national banks and 284 small federally chartered savings associations.

#### C. Projected Reporting, Recordkeeping, and Other Compliance Requirements

This NPR includes changes to the general risk-based capital requirements that address the calculation of risk-weighted assets and affect small banking organizations. The proposed rules in this NPR that would affect small banking organizations include:

1. Changing the denominator of the risk-based capital ratios by revising the asset risk weights;
2. Revising the treatment of counterparty credit risk;
3. Replacing references to credit ratings with alternative measures of creditworthiness;
4. Providing more comprehensive recognition of collateral and guarantees; and
5. Providing a more favorable capital treatment for transactions cleared through qualifying central counterparties.

These changes are designed to enhance the risk-sensitivity of the calculation of risk-weighted assets. Therefore, capital requirements may go down for some assets and up for others. For those assets with a higher risk weight under this NPR, however, that increase may be large in some instances, *e.g.*, requiring the equivalent of a dollar-for-dollar capital charge for some securitization exposures.

The Basel Committee on Banking Supervision has been conducting periodic reviews of the potential quantitative impact of the Basel III framework.<sup>90</sup> Although these reviews monitor the impact of implementing the Basel III framework rather than the proposed rule, the OCC is using estimates consistent with the Basel Committee's analysis, including a conservative estimate of a 20 percent increase in risk-weighted assets, to gauge the impact of this NPR on risk-weighted assets. Using this assumption, the OCC estimates that a total of 56 small national banks and federally chartered savings associations will need

to raise additional capital to meet their regulatory minimums. The OCC estimates that this total projected shortfall will be \$143 million and that the cost of lost tax benefits associated with increasing total capital by \$143 million will be approximately \$0.8 million per year. Averaged across the 56 affected institutions, the cost is approximately \$14,000 per institution per year.

To comply with the proposed rules in this NPR, covered small banking organizations would be required to change their internal reporting processes. These changes would require some additional personnel training and expenses related to new systems (or modification of existing systems) for calculating regulatory capital ratios.

Additionally, covered small banking organizations that hold certain exposures would be required to obtain additional information under the proposed rules in order to determine the applicable risk weights. Covered small banking organizations that hold exposures to sovereign entities other than the United States, foreign depository institutions, or foreign public sector entities would have to acquire Country Risk Classification ratings produced by the OECD to determine the applicable risk weights. Covered small banking organizations that hold residential mortgage exposures would need to have and maintain information about certain underwriting features of the mortgage as well as the LTV ratio in order to determine the applicable risk weight. Generally, covered small banking organizations that hold securitization exposures would need to obtain sufficient information about the underlying exposures to satisfy due diligence requirements and apply either the simplified supervisory formula or the gross-up approach described in section \_\_\_\_\_.43 of this NPR to calculate the appropriate risk weight, or be required to assign a 1,250 percent risk weight to the exposure.

Covered small banking organizations typically do not hold significant exposures to foreign entities or securitization exposures, and the agencies expect any additional burden related to calculating risk weights for these exposures, or holding capital against these exposures, would be relatively modest. The OCC estimates that, for small national banks and federal savings associations, the cost of implementing the alternative measures of creditworthiness will be approximately \$36,125 per institution.

Some covered small banking organizations may hold significant residential mortgage exposures.

<sup>86</sup> 5 U.S.C. 603(a).

<sup>87</sup> 5 U.S.C. 605(b).

<sup>88</sup> *See, e.g.*, 12 U.S.C. 1467a(g)(1); 12 U.S.C. 1831o(c)(1); 12 U.S.C. 1844; 12 U.S.C. 3907; and 12 U.S.C. 5371.

<sup>89</sup> *See* 13 CFR 121.201.

<sup>90</sup> *See*, "Update on Basel III Implementation Monitoring," Quantitative Impact Study Working Group, January 28, 2012.



However, if the small banking organization originated the exposure, it should have sufficient information to determine the applicable risk weight under the proposed rule. If the small banking organization acquired the exposure from another institution, the information it would need to determine the applicable risk weight is consistent with information that it should normally collect for portfolio monitoring purposes and internal risk management.

Covered small banking organizations would not be subject to the disclosure requirements in subpart D of the proposed rule. However, the agencies expect to modify regulatory reporting requirements that apply to covered small banking organizations to reflect the changes made to the agencies' capital requirements in the proposed rules. The agencies expect to propose these changes to the relevant reporting forms in a separate notice.

To determine if a proposed rule has a significant economic impact on small entities we compared the estimated annual cost with annual noninterest expense and annual salaries and employee benefits for each small entity. If the estimated annual cost was greater than or equal to 2.5 percent of total noninterest expense or 5 percent of annual salaries and employee benefits we classified the impact as significant. The OCC has concluded that the proposals included in this NPR would exceed this threshold for 500 small national banks and 253 small federally chartered private savings institutions. Accordingly, for the purposes of this IRFA, the OCC has concluded that the changes proposed in this NPR, when considered without regard to other changes to the capital requirements that the agencies simultaneously are proposing, would have a significant economic impact on a substantial number of small entities.

Additionally, as discussed in the Supplementary Information section above, the changes proposed in this NPR should be considered together with changes proposed in the separate Basel III NPR also published in today's **Federal Register**. The changes described in the Basel III NPR include changes to minimum capital requirements that would impact small national banks and federal savings associations. These include a more conservative definition of regulatory capital, a new common equity tier 1 capital ratio, a higher minimum tier 1 capital ratio, new thresholds for prompt corrective action purposes, and a new capital conservation buffer. To estimate the impact of the Basel III NPR on national

banks' and federal savings' association capital needs, the OCC estimated the amount of capital the banks will need to raise to meet the new minimum standards relative to the amount of capital they currently hold. To estimate new capital ratios and requirements, the OCC used currently available data from banks' quarterly Consolidated Report of Condition and Income (Call Reports) to approximate capital under the proposed rule, which shows that most banks have raised their capital levels well above the existing minimum requirements. After comparing existing levels with the proposed new requirements, the OCC determined that 28 small institutions that it regulates would fall short of the proposed increased capital requirements. Together, those institutions would need to raise approximately \$82 million in regulatory capital to meet the proposed minimum requirements set forth in the Basel III NPR. The OCC estimates that the cost of lost tax benefits associated with increasing total capital by \$82 million will be approximately \$0.5 million per year. Averaged across the 28 affected institutions, the cost attributed to the Basel III NPR is approximately \$18,000 per institution per year. The OCC concluded for purposes of its IRFA for the Basel III NPR that the changes described in the Basel III NPR, when considered without regard to changes in this NPR, would not result in a significant economic impact on a substantial number of small entities. However, the OCC has concluded that the proposed changes in this NPR would result in a significant economic impact on a substantial number of small entities. Therefore, considered together, this NPR and the Basel III NPR would have a significant economic impact on a substantial number of small entities.

#### D. Identification of Duplicative, Overlapping, or Conflicting Federal Rules

The OCC is unaware of any duplicative, overlapping, or conflicting federal rules. As noted previously, the OCC anticipates issuing a separate proposal to implement reporting requirements that are tied to (but do not overlap or duplicate) the requirements of the proposed rules. The OCC seeks comments and information regarding any such federal rules that are duplicative, overlapping, or otherwise in conflict with the proposed rule.

#### E. Discussion of Significant Alternatives to the Proposed Rule

The agencies have sought to incorporate flexibility into the proposed rule and lessen burden and complexity

for smaller banking organizations wherever possible, consistent with safety and soundness and applicable law, including the Dodd-Frank Act. The agencies are requesting comment on potential options for simplifying the rule and reducing burden, including whether to permit certain small banking organizations to continue using portions of the current general risk-based capital rules to calculate risk-weighted assets. Additionally, the agencies proposed the following alternatives and flexibility features:

- Covered small banking organizations are not subject to the enhanced disclosure requirements of the proposed rules.
- Covered small banking organizations would continue to apply a 100 percent risk weight to corporate exposures (as described in section \_\_\_\_\_.32 of this NPR).
- Covered small banking organizations may choose to apply the simpler gross-up method for securitization exposures rather than the Simplified Supervisory Formula Approach (SSFA) (as described in section \_\_\_\_\_.43 of this NPR).
- The proposed rule offers covered small banking organizations a choice between a simpler and more complex methods of risk weighting equity exposures to investment funds (as described in section \_\_\_\_\_.53 of this NPR).

The agencies welcome comment on any significant alternatives to the proposed rules applicable to covered small banking organizations that would minimize their impact on those entities.

## VII. Paperwork Reduction Act

### A. Request for Comment on Proposed Information Collection

In accordance with the requirements of the Paperwork Reduction Act (PRA) of 1995, the Agencies may not conduct or sponsor, and the respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number. The Agencies are requesting comment on a proposed information collection.

The information collection requirements contained in this joint notice of proposed rulemaking (NPRs) have been submitted by the OCC and FDIC to OMB for review under the PRA, under OMB Control Nos. 1557-0234 and 3064-0153. In accordance with the PRA (44 U.S.C. 3506; 5 CFR part 1320, Appendix A.1), the Board has reviewed the NPR under the authority delegated by OMB. The Board's OMB Control No. is 7100-0313. The requirements are

found in §§ \_\_\_\_.35, \_\_\_\_.37, \_\_\_\_.41, \_\_\_\_.42, \_\_\_\_.62, and \_\_\_\_.63.

The Agencies have published two other NPRs in this issue of the **Federal Register**. Please see the NPRs entitled "Regulatory Capital Rules: Regulatory Capital, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions" and "Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rules; Market Risk Capital Rule." While the three NPRs together comprise an integrated capital framework, the PRA burden has been divided among the three NPRs and a PRA statement has been provided in each.

Comments are invited on:

(a) Whether the collection of information is necessary for the proper performance of the Agencies' functions, including whether the information has practical utility;

(b) The accuracy of the estimates of the burden of the information collection, including the validity of the methodology and assumptions used;

(c) Ways to enhance the quality, utility, and clarity of the information to be collected;

(d) Ways to minimize the burden of the information collection on respondents, including through the use of automated collection techniques or other forms of information technology; and

(e) Estimates of capital or start up costs and costs of operation, maintenance, and purchase of services to provide information.

All comments will become a matter of public record.

Comments should be addressed to:

OCC: Communications Division, Office of the Comptroller of the Currency, Public Information Room, Mail stop 1-5, Attention: 1557-0234, 250 E Street SW., Washington, DC 20219. In addition, comments may be sent by fax to 202-874-4448, or by electronic mail to [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov). You can inspect and photocopy the comments at the OCC's Public Information Room, 250 E Street SW., Washington, DC 20219. You can make an appointment to inspect the comments by calling 202-874-5043.

**Board:** You may submit comments, identified by R-14441255, by any of the following methods:

- **Agency Web Site:** <http://www.federalreserve.gov>. Follow the instructions for submitting comments on the <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.
- **Federal eRulemaking Portal:** <http://www.regulations.gov>. Follow the instructions for submitting comments.

• **Email:**

[regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov). Include docket number in the subject line of the message.

• **Fax:** 202-452-3819 or 202-452-3102.

• **Mail:** Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue NW., Washington, DC 20551.

All public comments are available from the Board's Web site at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets NW.) between 9 a.m. and 5 p.m. on weekdays.

**FDIC:** You may submit written comments, which should refer to RIN 3064-AD96 Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements 0153, by any of the following methods:

• **Agency Web Site:** <http://www.fdic.gov/regulations/laws/federal/propose.html>. Follow the instructions for submitting comments on the FDIC Web site.

• **Federal eRulemaking Portal:** <http://www.regulations.gov>. Follow the instructions for submitting comments.

• **Email:** [Comments@FDIC.gov](mailto:Comments@FDIC.gov).

• **Mail:** Robert E. Feldman, Executive Secretary, Attention: Comments, FDIC, 550 17th Street NW., Washington, DC 20429.

• **Hand Delivery/Courier:** Guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7 a.m. and 5 p.m.

**Public Inspection:** All comments received will be posted without change to <http://www.fdic.gov/regulations/laws/federal/propose/html> including any personal information provided.

Comments may be inspected at the FDIC Public Information Center, Room 100, 801 17th Street NW., Washington, DC, between 9 a.m. and 4:30 p.m. on business days.

#### B. Proposed Information Collection

**Title of Information Collection:** Basel III, Part II.

**Frequency of Response:** On occasion and quarterly.

**Affected Public:**

**OCC:** National banks and federally chartered savings associations.

**Board:** State member banks, bank holding companies, and savings and loan holding companies.

**FDIC:** Insured state nonmember banks, state savings associations, and certain subsidiaries of these entities.

**Estimated Burden:** The burden estimates below exclude any regulatory reporting burden associated with changes to the Consolidated Reports of Income and Condition for banks (FFIEC 031 and FFIEC 0431; OMB Nos. 7100-0036, 3064-0052, 1557-0081), and the Financial Statements for Bank Holding Companies (FR Y-9; OMB No. 7100-0128), and the Capital Assessments and Stress Testing information collection (FR Y-14A/Q/M; OMB No. 7100-0341).

The agencies are still considering whether to revise these information collections or to implement a new information collection for the regulatory reporting requirements. In either case, a separate notice would be published for comment on the regulatory reporting requirements.

#### OCC

**Estimated Number of Respondents:** Independent national banks, 172; federally chartered savings banks, 603.

**Estimated Burden per Respondent:** One-time recordkeeping, 122 hours; ongoing recordkeeping, 20 hours; one-time disclosures, 226.25 hours; ongoing disclosures, 131.25 hours.

**Total Estimated Annual Burden:** 112,303.75 hours.

#### Board

**Estimated Number of Respondents:** SMBs, 831; BHCs, 933; SLHCs, 438.

**Estimated Burden per Respondent:** One-time recordkeeping, 122 hours; ongoing recordkeeping, 20 hours; one-time disclosures, 226.25 hours; ongoing disclosures, 131.25 hours.

**Total Estimated Annual Burden:** One-time recordkeeping and disclosures, 279,277.75 hours; ongoing recordkeeping and disclosures 68,715.

#### FDIC

**Estimated Number of Respondents:** 4,571.

**Estimated Burden per Respondent:** One-time recordkeeping, 122 hours; ongoing recordkeeping, 20 hours; one-time disclosures, 226.25 hours; ongoing disclosures, 131.25 hours.

**Total Estimated Annual Burden:** 652,087 hours (558,567 one-time recordkeeping and disclosures; 93,520 ongoing recordkeeping and disclosures).

**Abstract:**

The recordkeeping requirements are found in sections \_\_\_\_.35, \_\_\_\_.37, and \_\_\_\_.41. The disclosure requirements are found in sections \_\_\_\_.42, \_\_\_\_.62, and \_\_\_\_.63. These recordkeeping and disclosure requirements are necessary for the agencies' assessment and monitoring of

the risk-sensitivity of the calculation of a banking organization's total risk-weighted assets and for general safety and soundness purposes.

#### Section-by-section Analysis

##### Recordkeeping

Section .35 sets forth requirements for cleared transactions. Section .35(b)(3)(i)(A) would require for a cleared transaction with a qualified central counterparty (QCCP) that a client bank apply a risk weight of 2 percent, provided that the collateral posted by the bank to the QCCP is subject to certain arrangements and the client bank has conducted a sufficient legal review (and maintains sufficient written documentation of the legal review) to conclude with a well-founded basis that the arrangements, in the event of a legal challenge, would be found to be legal, valid, binding and enforceable under the law of the relevant jurisdictions. The agencies estimate that respondents would take on average 2 hours to reprogram and update systems with the requirements outlined in this section. In addition, the agencies estimate that, on a continuing basis, respondents would take on average 2 hours annually to maintain their internal systems.

Section .37 addresses requirements for collateralized transactions. Section .37(c)(4)(i)(E) would require that a bank have policies and procedures describing how it determines the period of significant financial stress used to calculate its own internal estimates for haircuts and be able to provide empirical support for the period used. The agencies estimate that respondents would take on average 80 hours (two business weeks) to reprogram and update systems with the requirements outlined in this section. In addition, the agencies estimate that, on a continuing basis, respondents would take on average 16 hours annually to maintain their internal systems.

Section .41 addresses operational requirements for securitization exposures. Section .41(b)(3) would allow for synthetic securitizations a bank's recognition, for risk-based capital purposes, of a credit risk mitigant to hedge underlying exposures if certain conditions are met, including the bank's having obtained a well-reasoned opinion from legal counsel that confirms the enforceability of the credit risk mitigant in all relevant jurisdictions. Section .41(c)(2)(i) would require that a bank support a demonstration of its comprehensive understanding of a securitization exposure by conducting and

documenting an analysis of the risk characteristics of each securitization exposure prior to its acquisition, taking into account a number of specified considerations. The agencies estimate that respondents would take on average 40 hours (one business week) to reprogram and update systems with the requirements outlined in this section. In addition, the agencies estimate that, on a continuing basis, respondents would take on average 2 hours annually to maintain their internal systems.

##### Disclosures

Section .42 addresses risk-weighted assets for securitization exposures. Section .42(e)(2) would require that a bank publicly disclose that is has provided implicit support to the securitization and the risk-based capital impact to the bank of providing such implicit support.

Section .62 sets forth disclosure requirements related to a bank's capital requirements. Section .62(a) specifies a quarterly frequency for the disclosure of information in the applicable tables set out in section 63 and, if a significant change occurs, such that the most recent reported amounts are no longer reflective of the bank's capital adequacy and risk profile, section .62(a) also would require the bank to disclose as soon as practicable thereafter, a brief discussion of the change and its likely impact. Section 62(a) would allow for annual disclosure of qualitative information that typically does not change each quarter, provided that any significant changes are disclosed in the interim. Section .62(b) would require that a bank have a formal disclosure policy approved by the board of directors that addresses its approach for determining the disclosures it makes. The policy would be required to address the associated internal controls and disclosure controls and procedures. Section 62(c) would require a bank with total consolidated assets of \$50 billion or more that is not an advanced approaches bank, if it concludes that specific commercial or financial information required to be disclosed under section .62 would be exempt from disclosure by the agency under the Freedom of Information Act (5 U.S.C. 552), to disclose more general information about the subject matter of the requirement and the reason the specific items of information have not been disclosed.

Section .63 sets forth disclosure requirements for banks with total consolidated assets of \$50 billion or more that are not advanced approaches banks. Section .63(a) would require a bank to make the disclosures in Tables

14.1 through 14.10 and in section .63(b) for each of the last three years beginning on the effective date of the rule. Section .63(b) would require quarterly disclosure of a bank's common equity tier 1 capital, additional tier 1 capital, tier 2 capital, tier 1 and total capital ratios, including the regulatory capital elements and all the regulatory adjustments and deductions needed to calculate the numerator of such ratios; total risk-weighted assets, including the different regulatory adjustments and deductions needed to calculate total risk-weighted assets; regulatory capital ratios during any transition periods, including a description of all the regulatory capital elements and all regulatory adjustments and deductions needed to calculate the numerator and denominator of each capital ratio during any transition period; and a reconciliation of regulatory capital elements as they relate to its balance sheet in any audited consolidated financial statements. Table 14.1 sets forth scope of application qualitative and quantitative disclosure requirements; Table 14.2 sets forth capital structure qualitative and quantitative disclosure requirements; Table 14.3 sets forth capital adequacy qualitative and quantitative disclosure requirements; Table 14.4 sets forth capital conservation buffer qualitative and quantitative disclosure requirements; Table 14.5 sets forth general qualitative and quantitative disclosure requirements for credit risk; Table 14.6 sets forth general qualitative and quantitative disclosure requirements for counterparty credit risk-related exposures; Table 14.7 sets forth qualitative and quantitative disclosure requirements for credit risk mitigation; Table 14.8 sets forth qualitative and quantitative disclosure requirements for securitizations; Table 14.9 sets forth qualitative and quantitative disclosure requirements for equities not subject to Subpart F of the rule; and Table 14.10 sets forth qualitative and quantitative disclosure requirements for interest rate risk for non-trading activities.

The agencies estimate that respondents would take on average 226.25 hours to reprogram and update systems with the requirements outlined in these sections. In addition, the agencies estimate that, on a continuing basis, respondents would take on average 131.25 hours annually to maintain their internal systems.

#### VIII. Plain Language

Section 722 of the Gramm-Leach-Bliley Act requires the Federal banking agencies to use plain language in all

proposed and final rules published after January 1, 2000. The agencies invited comment on whether the proposed rule was written plainly and clearly or whether there were ways the agencies could make the rule easier to understand. The agencies received no comments on these matters and believe that the final rule is written plainly and clearly in conjunction with the agencies' risk-based capital rules.

### IX. OCC Unfunded Mandates Reform Act of 1995 Determination

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) (2 U.S.C. 1532 *et seq.*) requires that an agency prepare a written statement before promulgating a rule that includes a Federal mandate that may result in the expenditure by State, local, and Tribal governments, in the aggregate, or by the private sector of \$100 million or more (adjusted annually for inflation) in any one year. If a written statement is required, the UMRA (2 U.S.C. 1535) also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule and from those alternatives, either select the least costly, most cost-effective or least burdensome alternative that achieves the objectives of the rule, or provide a statement with the rule explaining why such an option was not chosen.

Under this NPR, the OCC is proposing changes to their minimum capital requirements that address the calculation of risk-weighted assets. The proposed rule would:

1. Change denominator of the risk-based capital ratios by revising the methodologies for calculating risk weights;
2. Revise the treatment of counterparty credit risk;
3. Replace references to credit ratings with alternative measures of creditworthiness;
4. Provide more comprehensive recognition of collateral and guarantees;
5. Provide a more favorable capital treatment for transactions cleared through qualifying central counterparties; and
6. Introduce disclosure requirements for banking organizations with assets of \$50 billion or more.

To estimate the impact of this NPR on national banks and federal savings associations, the OCC estimated the amount of capital banks will need to raise to meet the new minimum standards relative to the amount of capital they currently hold, as well as the compliance costs associated with establishing the infrastructure to determine correct risk weights using the

new alternative measures of creditworthiness and the compliance costs associated with new disclosure requirements. The OCC has determined that its NPR will not result in expenditures by State, local, and Tribal governments, or by the private sector, of \$100 million or more (adjusted annually for inflation). Accordingly, the UMRA does not require that a written statement accompany this NPR.

### Addendum 1: Summary of this NPR for Community Banking Organizations Overview

The agencies are issuing a notice of proposed rulemaking (NPR, proposal, or proposed rule) to harmonize and address shortcomings in the measurement of risk-weighted assets that became apparent during the recent financial crisis, in part by implementing in the United States changes made by the Basel Committee on Banking Supervision (BCBS) to international regulatory capital standards and by implementing aspects of the Dodd-Frank Act. Among other things, the proposed rule would:

- Revise risk weights for residential mortgages based on loan-to-value ratios and certain product and underwriting features;
- Increase capital requirements for past-due loans, high volatility commercial real estate exposures, and certain short-term loan commitments;
- Expand the recognition of collateral and guarantors in determining risk-weighted assets;
- Remove references to credit ratings; and
- Establish due diligence requirements for securitization exposures.

*This addendum presents a summary of the proposal in this NPR that is most relevant for smaller, less complex banking organizations that are not subject to the market risk capital rule or the advanced approaches capital rule, and that have under \$50 billion in total assets. The agencies intend for this addendum to act as a guide for these banking organizations, helping them to navigate the proposed rule and identify the changes most relevant to them. The addendum does not, however, by itself provide a complete understanding of the proposed rules and the agencies expect and encourage all institutions to review the proposed rule in its entirety.*

#### A. Zero Percent Risk-weighted Items

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

- Cash;
- Certain gold bullion;
- 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 (as discussed below).

*For more information, please refer to sections 32(a) and 37(b)(3)(iii) of the proposal. For exposures to foreign governments and their central banks, see section L below.*

#### B. 20 Percent Risk Weighted Items

The following exposures would receive a twenty percent risk weight under the proposal:

- 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 National Credit Union Administration (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 proposal) in the United States; and
- 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 (as described below).

A conditional guarantee is one that requires the satisfaction of certain conditions, for example servicing requirements.

*For more information, please refer to sections 32(a) through 32(e), and section 32(l) of the proposal. For exposures to foreign banks and public sector entities, see section L below.*

#### C. 50 Percent Risk-weighted Exposures

The following exposures would receive a 50 percent risk weight under the proposal:

- "Statutory" multifamily mortgage loans meeting certain criteria;
- Presold residential construction loans meeting certain criteria;
- 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 described below).

The criteria for multifamily loans and presold residential construction loans are generally the same as in the existing general risk-based capital rules. These criteria are required under federal law.<sup>91</sup> Consistent with the general risk-based capital rules and requirements of the statute, the proposal would assign a 100 percent risk weight to pre-sold construction loans where the contract is cancelled.

*For more information, please refer to sections 32(e), 32(h), and 32(i) of the proposal. Also refer to section 2 of the proposal for relevant definitions:*

—*Pre-sold construction loan.*

—*Revenue obligation.*

—*Statutory multifamily mortgage.*

<sup>91</sup> See sections 618(a)(1) or (2) and 618(b)(1) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991.

**D. 1–4 Family Residential Mortgage Loans**

Under the proposed rule, 1–4 family residential mortgages would be separated into two risk categories (“category 1 residential mortgage exposures” and “category 2 residential mortgage exposures”) based on certain product and underwriting characteristics. The proposed definition of

category 1 residential mortgage exposures would generally include traditional, first-lien, prudently underwritten mortgage loans. The proposed definition of category 2 residential mortgage exposures would generally include junior-liens and non-traditional mortgage products.

The proposal would not recognize private mortgage insurance (PMI) for purposes of

calculating the loan to value (LTV) ratio. Therefore, the LTV levels in the table below 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 percent)	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

*Definitions:*

*Category 1 residential mortgage exposure* would mean a residential mortgage exposure with the following characteristics:

- 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 two percentage points in any twelve-month period and no more than six percentage points over the life of the loan;
- For a first-lien home equity line of credit (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 residential mortgage exposure* would mean a residential mortgage exposure that is not a Category 1 residential mortgage exposure and is not guaranteed by the U.S. government.

*LTV ratio* would equal the loan amount divided by the value of the property.

*Loan Amount:*

- For a first-lien residential mortgage, the loan amount 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. However, for a loan whose balance may increase under the terms of the mortgage, such as pay-option adjustable loan that can negatively amortize or for a HELOC, the loan amount is the maximum contractual principal amount of the loan.
- For a junior-lien mortgage, the loan amount would be the maximum contractual principal amount of the loan plus the maximum contractual principal amounts of all more senior loans secured by the same residential property on the date of origination of the junior-lien residential mortgage.

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. The banking organization must base all estimates of a property’s value on an appraisal or evaluation of the property that meets the requirements of the primary federal supervisor’s appraisal regulations.<sup>92</sup>

If a banking organization holds a first mortgage and junior-lien mortgage on the same residential property and there is no intervening lien, the proposal treats the combined exposure as a single first-lien mortgage exposure.

If a banking organization holds two or more mortgage loans on the same residential property, and one of the loans is category 2, then the banking organization would be required to treat all of the loans on the property as category 2.

*Additional Notes:*

<sup>92</sup> The appraisal or evaluation must satisfy the requirements of 12 CFR part 34, subpart C, 12 CFR part 164 (OCC); 12 CFR part 208, subpart E (Board); 12 CFR part 323, 12 CFR 390.442 (FDIC).

- 1–4 family mortgage loans sold with recourse are converted to an on-balance sheet credit equivalent amount using a 100 percent conversion factor. There is no grace period, such as the 120-day exception under the current general risk-based capital rules.
- Restructured and modified mortgages would be assigned risk weights based on their LTVs and classification as category 1 or category 2 residential mortgage exposures 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 percent and a category 2 residential mortgage would receive a risk weight of 200 percent.
- Similar to the current capital rules, loans modified or restructured under the Treasury’s Home Affordable Mortgage Program (HAMP) would not be considered modified or restructured for the purposes of the proposal.

*For more information, please refer to section 32(g) of the proposal. Also refer to section 2 for relevant definitions:*

- Category 1 residential mortgage exposure*
- Category 2 residential mortgage exposure*
- First lien residential mortgage exposure*
- Junior-lien residential mortgage*
- Residential mortgage exposure*

**E. Past Due Exposures**

The proposal would assign a 150 percent risk weight to loans and other exposures that are 90 days or more past due. This applies to all exposure categories *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 in section D).
- A sovereign exposure where the sovereign has experienced a sovereign default.

*For more information, please refer to section 32(k) of the proposal.*

**F. High-Volatility Commercial Real Estate Loans (HVCRE)**

The proposal would assign a 150 percent risk weight to HVCRE exposures. The

proposal defines an HVCRE exposure 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 percent of the real estate’s appraised “as completed” value; and
  - The borrower contributed the amount of capital required by this definition before the banking organization advances funds 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.

*For more information please refer to section 32 of the proposal. Also refer to section 2 for relevant definitions:*

- High-volatility commercial real estate exposure (HVCRE)

**G. Commercial Loans/Corporate Exposures**

The proposal would assign a 100 percent 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.

*For more information please refer to section 32(f) of the proposal, and section 33 for off-balance sheet exposures.*

**H. Consumer Loans and Credit Cards**

Under the proposed rule, consumer loans and credit cards would continue to receive a 100 percent risk weight. The proposal does not specifically list these assets, but they fall into the “other assets” category that would receive a 100 percent risk weight.

*For more information, please refer to section 32(l) of the proposal.*

**I. Basel III Risk Weight Items**

As described in the Basel III NPR, the amounts of the threshold deduction items (mortgage servicing assets, certain deferred tax assets, and investments in the common equity of financial institutions) that are not deducted would be assigned a risk weight of 250 percent. In addition, certain high-risk exposures such as credit-enhancing interest-only (CEIO) strips would receive 1,250 percent risk weight.

**J. Other Assets and Exposures**

Where the proposal does not assign a specific risk weight to an asset or exposure type, the applicable risk weight would be 100 percent. For example, premises, fixed assets, and other real estate owned receive a risk weight of 100 percent. Section 32(m) of the proposal for bank holding companies and savings and loan holding companies provides specific risk weights for certain insurance-related assets.

*For more information, please refer to section 32(l) of the proposal.*

**K. Conversion Factors for Off-balance Sheet Items**

Similar to the current rules, under the proposal, a banking organization would be required to calculate the exposure amount of an off-balance sheet exposure using the credit conversion factors (CCFs) below. The proposal increases the CCR for commitments with an original maturity of one year or less from zero percent to 20 percent.

- Zero percent CCF. A banking organization would apply a zero percent CCF to the unused portion of commitments that are unconditionally cancelable by the banking organization.
- 20 percent CCF. A banking organization would apply a 20 percent CCF to:
  - Commitments with an original maturity of one year or less that are not unconditionally cancelable by the banking organization.
  - Self-liquidating, trade-related contingent items that arise from the movement of goods, with an original maturity of one year or less.
- 50 percent CCF. A banking organization would apply a 50 percent CCF to:
  - Commitments with an original maturity of more than one year that are not unconditionally cancelable by the banking organization.

- Transaction-related contingent items, including performance bonds, bid bonds, warranties, and performance standby letters of credit.
- 100 percent CCF. A banking organization would apply a 100 percent CCF to the following off-balance-sheet items and other similar transactions:
  - Guarantees;
  - Repurchase agreements (the off-balance sheet component of which equals the sum of the current market values of all positions the banking organization has sold subject to repurchase);
  - Off-balance sheet securities lending transactions (the off-balance sheet component of which equals the sum of the current market values of all positions the banking organization has lent under the transaction);
  - Off-balance sheet securities borrowing transactions (the off-balance sheet component of which equals the sum of the current market values of all non-cash positions the banking organization has posted as collateral under the transaction);
  - Financial standby letters of credit; and
  - Forward agreements.

*For more information please refer to section 33 of the proposal. Also refer to section 2 for the definition of unconditionally cancelable.*

**L. Over-the-Counter (OTC) Derivative Contracts**

The proposal provides a method for determining the risk-based capital requirement for a derivative contract that is similar to the general risk-based capital rules. Under the proposed rule, the banking organization would determine the exposure amount and then assign a risk weight based on the counterparty or collateral. The exposure amount is the sum of current exposures plus potential future credit exposures (PFEs). In contrast to the general risk-based capital rules, which place a 50 percent risk weight cap on derivatives, the proposal does not include a risk weight cap and introduces specific credit conversion factors for credit derivatives.

The current credit exposure is the greater of zero or the mark-to-market value of the derivative contract.

The PFE is generally the notional amount of the derivative contract multiplied by a credit conversion factor for the type of derivative contract. The table below shows the credit conversion factors for derivative contracts:

CONVERSION FACTOR MATRIX FOR DERIVATIVE CONTRACTS <sup>1</sup>

Remaining maturity <sup>2</sup>	Interest rate (percent)	Foreign exchange rate and gold (percent)	Credit (investment-grade <sup>3</sup> reference asset) <sup>4</sup> (percent)	Credit (non-investment-grade reference asset) (percent)	Equity (percent)	Precious metals (except gold) (percent)	Other (percent)
One year or less .....	0.0	1.0	5.0	10.0	6.0	7.0	10.0
Greater than one year and less than or equal to five years .....	0.5	5.0	5.0	10.0	8.0	7.0	12.0

CONVERSION FACTOR MATRIX FOR DERIVATIVE CONTRACTS <sup>1</sup>—Continued

Remaining maturity <sup>2</sup>	Interest rate (percent)	Foreign exchange rate and gold (percent)	Credit (investment-grade <sup>3</sup> reference asset) <sup>4</sup> (percent)	Credit (non-investment-grade reference asset) (percent)	Equity (percent)	Precious metals (except gold) (percent)	Other (percent)
Greater than five years .....	1.5	7.5	5.0	10.0	10.0	8.0	15.0

<sup>1</sup> For a derivative contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the derivative contract.

<sup>2</sup> For an OTC derivative contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the contract is zero, the remaining maturity equals the time until the next reset date. For an interest rate derivative contract with a remaining maturity of greater than one year that meets these criteria, the minimum conversion factor is 0.005.

<sup>3</sup> As proposed, "investment grade" would mean that the entity to which the banking organization is exposed through a loan or security, or the reference entity with respect to a credit derivative, has adequate capacity to meet financial commitments for the projected life of the asset or exposure. Such an entity or reference entity has adequate capacity to meet financial commitments if the risk of its default is low and the full and timely repayment of principal and interest is expected.

<sup>4</sup> A [BANK] must use the column labeled "Credit (investment-grade reference asset)" for a credit derivative whose reference asset is an outstanding unsecured long-term debt security without credit enhancement that is investment grade. A [BANK] must use the column labeled "Credit (non-investment-grade reference asset)" for all other credit derivatives.

For more information please refer to section 34 of the proposal. Also refer to section 2 for relevant definitions:

- Effective notional amount
- Eligible credit derivative
- Eligible derivative contract
- Exposure amount
- Interest rate derivative contract

#### M. Securitization Exposures

Section 42 of the proposal introduces due diligence requirements for banking organizations that own, originate or purchase securitization exposures and introduces a new definition of securitization exposure. If a banking organization is unable to demonstrate to the satisfaction of its primary federal supervisor a comprehensive understanding of the features of a securitization exposure that would materially affect the performance of the exposure, the banking organization would be required to assign the securitization exposure a risk weight of 1,250 percent. The banking organization's analysis would be required to be commensurate with the complexity of the securitization exposure and the materiality of the exposure in relation to capital.

Note that mortgage-backed pass-through securities (for example, those guaranteed by Federal Home Loan Mortgage Corporation (FHLMC) or Federal National Mortgage Association (FNMA)) do not meet the proposed definition of a securitization exposure because they do not involve a tranching of credit risk. Rather, only those mortgage-backed securities that involve tranching of credit risk would be securitization exposures. For securitization exposures guaranteed by the U.S. Government or GSEs, there are no changes relative to the existing treatment:

- The Government National Mortgage Association (Ginnie Mae) securities receive a zero percent risk weight to the extent they are unconditionally guaranteed.

—The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) guaranteed securities receive a 20 percent risk weight.

—Fannie Mae and Freddie Mac non-credit enhancing interest-only (IO) securities receive a 100 percent risk weight.

The risk-based capital requirements for securitizations under the proposed rule would be as follows:

—A banking organization would deduct any after-tax gain-on-sale of a securitization. (This requirement would usually pertain to banking organizations that are securitizers rather than purchasers of securitization exposures);

—A banking organization would assign a 1,250 percent risk weight to a CEIO.

—A banking organization would assign a 100 percent risk weight to non-credit enhancing IO mortgage-backed securities.

For privately-issued mortgage securities and all other securitization exposures, a banking organization would be able choose among the following approaches, provided that the banking organization consistently applies such approach to all securitization exposures:<sup>93</sup>

—A banking organization may use the existing gross-up approach to risk weight all of its securitizations. Under the existing gross-up approach, senior securitization tranches are assigned the risk weight associated with the underlying exposures. A banking organization must hold capital for the senior tranche based on the risk weight of the underlying exposures. For subordinate securitization tranches, a banking organization must hold capital for the subordinate tranche, as well as all more senior tranches for which the subordinate tranche provides credit support.

—A banking organization may determine the risk weight for the securitization exposure

using the simplified supervisory formula approach (SSFA) described in section 43 of the proposal. The SSFA formula would require a banking organization to apply a supervisory formula that requires various data inputs including the risk weight applicable to the underlying exposures; the attachment and detachment points of the securitization tranche, which is the relative position of the securitization position in the structure (subordination); and the current percentage of the underlying exposures that are 90 days or more past due, in default, or in foreclosure. Banking organizations considering the SSFA approach should carefully read and consider section 43 of the proposal.

Alternatively, a banking organization may apply a 1,250 percent risk weight to any of its securitization exposures.

For more information, please refer to sections 42–45 of the proposal. Also refer to section 2 for the following definitions:

- Credit-enhancing interest-only strip
- Gain-on-sale
- Resecuritization
- Resecuritization exposure
- Securitization exposure
- Securitization special purpose entity (securitization SPE)
- Synthetic securitization
- Traditional securitization
- Underlying exposure

#### N. Equity Exposures

Under section 52 of the proposal, a banking organization would apply a simple risk-weight approach (SRWA) to determine the risk weight for equity exposures that are not exposures to an investment fund. The following table indicates the risk weights that would apply to equity exposures under the SRWA:

<sup>93</sup> The ratings-based approach for externally-rated positions would no longer be available.



Risk weight (in percent)	Equity exposure
0 .....	An equity exposure to a sovereign entity, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, a MDB, and any other entity whose credit exposures receive a zero percent risk weight under section 32 of this proposed rule.
20 .....	An equity exposure to a public sector entity, Federal Home Loan Bank or the Federal Agricultural Mortgage Corporation (Farmer Mac).
100 .....	<ul style="list-style-type: none"> <li>• Community development equity exposures.<sup>94</sup></li> <li>• The effective portion of a hedge pair.</li> <li>• Non-significant equity exposures to the extent that the aggregate adjusted carrying value of the exposures does not exceed 10 percent of tier 1 capital plus tier 2 capital.</li> </ul>
250 .....	A significant investment in the capital of an unconsolidated financial institution that is not deducted under section 22.
300 .....	A publicly-traded equity exposure (other than an equity exposure that receives a 600 percent risk weight and including the ineffective portion of a hedge pair).
400 .....	An equity exposure that is not publicly-traded (other than an equity exposure that receives a 600 percent risk weight).
600 .....	An equity exposure to a hedge fund or other investment firm that has greater than immaterial leverage.

For more information, please refer to sections 51 and 52 of the proposal, and any related definitions in section 2:

- Equity exposure
- Equity derivative contract

**O. Equity Exposures to Investment Funds**

The proposals described in this section would apply to equity exposures to investment funds such as mutual funds, but not to hedge funds or other leveraged investment funds (refer to section above). For exposures to investment funds other than community development exposures, a banking organization must use one of three risk-weighting approaches described below:

1. *Full look-through approach:*

For this two-step approach, a banking organization would be required to obtain information regarding the asset pool underlying the investment fund as of the date of the calculation, as well as the banking organization’s proportional share of ownership in the fund. For the first step the banking organization would assign risk weights to the assets of the entire investment fund and calculates the sum of those risk-weighted assets. For the second step, the banking organization would multiply the sum of the fund’s risk-weighted assets by the banking organization’s proportional ownership in the fund.

2. *Simple modified look-through approach:*

<sup>94</sup> The proposed rule generally defines Community Development Exposures as exposures that would qualify as community development investments under 12 U.S.C. 24(Eleventh), excluding equity exposures to an unconsolidated small business investment company and equity exposures held through a consolidated small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682). For savings associations, community development investments would be defined to mean equity investments that are designed primarily to promote community welfare, including the welfare of low- and moderate-income communities or families, such as by providing services or jobs, and excluding equity exposures to an unconsolidated small business investment company and equity exposures held through a consolidated small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682).

Similar to the current capital rules, under this approach a banking organization would multiply the adjusted carrying value of its investment in the fund by the highest risk weight that applies to any exposure the fund is permitted to hold as described in the prospectus or fund documents.

3. *Alternative modified look-through approach:*

Similar to the current capital rules, under this approach a banking organization would assign the adjusted carrying value of an equity exposure to an investment fund on a pro rata basis to different risk-weight categories based on the investment limits described in the fund’s prospectus. The banking organization’s risk-weighted asset amount is the sum of each portion of the adjusted carrying value assigned to an exposure type multiplied by the applicable risk weight under section 32 of the proposal. For purposes of the calculation the banking organization must assume the fund is invested in assets with the highest risk weight permitted by its prospectus and to the maximum amounts permitted.

For community development exposures, a banking organization’s risk-weighted asset amount is equal to its adjusted carrying value for the fund.

For more information please refer to section 53 of the proposal. Also refer to section 2 for relevant definitions:

- Adjusted carrying value
- Investment fund

**P. Treatment of Guarantees**

The proposal would allow a banking organization to substitute the risk weight of an eligible guarantor for the risk weight otherwise applicable to the guaranteed exposure. This treatment would apply only to *eligible guarantees* and *eligible credit derivatives*, and would provide certain adjustments for maturity mismatches, currency mismatches, and situations where restructuring is not treated as a credit event.

Under the proposal, eligible guarantors would include sovereign entities, certain supranational entities such as the International Monetary Fund, Federal Home Loan Banks, Farmer Mac, a multilateral development bank, a depository institution, a bank holding company, a savings and loan

holding company, a foreign bank, or an entity that has investment-grade debt, whose creditworthiness is not positively correlated with the credit risk of the exposures for which it provides guarantees. Eligible guarantors *would not* include monoline insurers, re-insurers, or special purpose entities.

To be an *eligible guarantee*, the guarantee would be required to be from an *eligible guarantor* and must meet the requirements of the proposal, including that the guarantee must:

- Be written;
- Be either:
  - Unconditional, or
  - A contingent obligation of the U.S. government or its agencies, the enforceability of which to the beneficiary is dependent upon some affirmative action on the part of the beneficiary of the guarantee or a third party (for example, servicing requirements);
- Cover all or a pro rata portion of all contractual payments of the obligor on the reference exposure;
- Give the beneficiary a direct claim against the protection provider; and
- And meet other requirements of the rule.

For more information please refer to section 36 of the proposal. Also refer to section 2 for relevant definitions:

- Eligible guarantee
- Eligible guarantor

**Q. Treatment of Collateralized Transactions**

The proposal allows banking organizations to recognize the risk mitigating benefits of financial collateral in risk-weighted assets, and defines financial collateral to include:

- Cash on deposit at the bank or third-party custodian;
- Gold;
- Investment grade long-term securities (excluding resecritizations);
- Investment grade short-term instruments (excluding resecritizations);
- Publicly-traded equity securities;
- Publicly-traded convertible bonds; and,
- Money market mutual fund shares; and other mutual fund shares if a price is quoted daily.



In all cases the banking organization would be required to have a perfected, first priority interest in the financial collateral.

1. *Simple approach:* A banking organization may apply a risk weight to the portion of an exposure that is secured by the market value of financial collateral by using the risk weight of the collateral—subject to a risk weight floor of 20 percent. To apply the simple approach, the collateral must be subject to a collateral agreement for at least the life of the exposure; the collateral must be revalued at least every 6 months; and the collateral (other than gold) must be in the same currency. There would be a few limited exceptions to the 20 percent risk weight floor:

- A banking organization may assign a zero percent risk weight to the collateralized portion of an exposure where:
  - The financial collateral is cash on deposit; or
  - The financial collateral is an exposure to a sovereign that qualifies for a zero percent

risk weight (including the United States) and the banking organization has discounted the market value of the collateral by 20 percent.

—A banking organization would be permitted to assign a zero percent risk weight to an exposure to an OTC derivative contract that is marked-to-market on a daily basis and subject to a daily margin maintenance requirement, to the extent the contract is collateralized by cash on deposit.

—A banking organization would be permitted to assign a 10 percent risk weight to an exposure to an OTC derivative contract that is marked-to-market on a daily basis and subject to a daily margin maintenance requirement, to the extent the contract is collateralized by U.S. government securities or an exposure to a sovereign that qualifies for a zero percent risk weight under the proposal.

2. *Collateral Haircut Approach:* For an eligible margin loan, a repo-style transaction,

a collateralized derivative contract, or a single-product netting set of such transactions, a banking organization may instead decide to use the *collateral haircut approach* to recognize the credit risk mitigation benefits of eligible collateral by reducing the amount of the exposure to be risk weighted rather than by substituting the risk weight of the collateral. Banking organizations considering the collateral haircut approach should carefully read section 37 of the proposal. The collateral haircut approach takes into account the value of the banking organization's exposure, the value of the collateral, and haircuts to account for potential volatility in position values and foreign exchange rates. The haircuts may be determined using one of two methodologies.

A banking organization may use standard haircuts based on the table below and a standard foreign exchange rate haircut of 8 percent.

**STANDARD SUPERVISORY MARKET PRICE VOLATILITY HAIRCUTS <sup>1</sup>**

Residual maturity	Haircut (in percents) assigned based on:						Investment grade securitization exposures (in percent)
	Sovereign issuers risk weight under § _____.32 <sup>2</sup>			Non-sovereign issuers risk weight under § _____.32			
	Zero %	20% or 50%	100%	20%	50%	100%	
Less than or equal to 1 year .....	0.5	1.0	15.0	1.0	2.0	25.0	4.0
Greater than 1 year and less than or equal to 5 years .....	2.0	3.0	15.0	4.0	6.0	25.0	12.0
Greater than 5 years .....	4.0	6.0	15.0	8.0	12.0	25.0	24.0
Main index equities (including convertible bonds) and gold	15.0						Highest haircut applicable to any security in which the fund can invest. Zero.
Other publicly-traded equities (including convertible bonds)	25.0						
Mutual funds	Zero.						
Cash collateral held	Zero.						

<sup>1</sup> The market price volatility haircuts in Table 2 are based on a 10 business-day holding period.

<sup>2</sup> Includes a foreign PSE that receives a zero percent risk weight.

*Alternatively*, a banking organization may, with supervisory approval, use own estimates of collateral haircuts when calculating the appropriate capital charge for an eligible margin loan, a repo-style transaction, or a collateralized derivative contract. Section 37 of the proposal provides the requirements for calculating own estimates, including the requirement that such estimates be determined based on a period of market stress appropriate for the collateral under this approach.

For more information, please refer to section 37 of the proposal. Also refer to section 2 for relevant definitions:

- Financial collateral
- Repo-style transaction

**R. Treatment of Cleared Transactions**

The proposal introduces a specific capital treatment for exposures to central counterparties (CCPs), including certain transactions conducted through clearing members by banking organizations that are not themselves clearing members of a CCP. Section 35 of the proposal describes the capital treatment of cleared transactions and of default fund exposures to CCPs, including

more favorable capital treatment for cleared transactions through CCPs that meet certain criteria.

**S. Unsettled Transactions**

The proposal provides for a separate risk-based capital requirement for transactions involving securities, foreign exchange instruments, and commodities that have a risk of delayed settlement or delivery. The proposed capital requirement would not, however, apply to certain types of transactions, including cleared transactions that are marked-to-market daily and subject to daily receipt and payment of variation margin. The proposal contains separate treatments for delivery-versus-payment (DvP) and payment-versus-payment (PvP) transactions with a normal settlement period, and non-DvP/non-PvP transactions with a normal settlement period.

**T. Foreign Exposures**

Under the proposal a banking organization would risk weight an exposure to a foreign government, foreign public sector entity (PSE), and a foreign bank based on the Country Risk Classification (CRC) that is

applicable to the foreign government, or the home country of the foreign PSE or foreign bank.

*Country risk classification (CRC)* for a sovereign means the CRC published by the Organization for Economic Co-operation and Development.

The risk weights for foreign sovereigns, foreign banks, and foreign PSEs are shown in the tables below:

**RISK WEIGHTS FOR FOREIGN SOVEREIGN EXPOSURES**

	Risk weight (in percent)
Sovereign CRC:	
0-1 .....	0
2 .....	20
3 .....	50
4-6 .....	100
7 .....	150
No CRC .....	100
Sovereign Default .....	150

—A sovereign exposure would be assigned a 150 percent risk weight immediately upon

determining that an event of sovereign default has occurred, or if an event of sovereign default has occurred during the previous five years.

**RISK WEIGHTS FOR EXPOSURES TO FOREIGN BANKS**

	Risk weight (in percent)
Sovereign CRC:	
0-1 .....	20
2 .....	50
3 .....	100
4-7 .....	150
No CRC .....	100
Sovereign Default .....	150

**RISK WEIGHTS FOR FOREIGN PSE GENERAL OBLIGATIONS**

	Risk weight (in percent)
Sovereign CRC:	
0-1 .....	20
2 .....	50
3 .....	100
4-7 .....	150
No CRC .....	100
Sovereign Default .....	150

**RISK WEIGHTS FOR FOREIGN PSE REVENUE OBLIGATIONS—Continued**

	Risk weight (in percent)
2-3 .....	100
4-7 .....	150
No CRC .....	100
Sovereign Default .....	150

**RISK WEIGHTS FOR FOREIGN PSE REVENUE OBLIGATIONS**

	Risk weight (in percent)
Sovereign CRC:	
0-1 .....	50

For more information, please refer to section 32(a), 32(d), and 32(e) of the proposal. Also refer to section 2 for relevant definitions:

- Home country
- Public sector entity (PSE)
- Sovereign
- Sovereign exposure

The following is a table summarizing the proposed changes to the general risk-based capital rules for risk weighting assets.

**COMPARISON OF CURRENT RULES VS. PROPOSAL**

Category	Current risk weight (in general)	Proposal	Comments
<b>Risk Weights for On-Balance Sheet Exposures Under Current and Proposed Rules</b>			
Cash .....	0% .....	0% .....	
Direct and unconditional claims on the U.S. Government, its agencies, and the Federal Reserve.	0% .....	0% .....	
Claims on certain supranational entities and multilateral development banks.	20% .....	0% .....	Claims on supranational entities include, for example, claims on the International Monetary Fund.
Cash items in the process of collection.	20% .....	20% .....	
Conditional claims on the U.S. government.	20% .....	20% .....	A conditional claim is one that requires the satisfaction of certain conditions, for example, servicing requirements.
Claims on government-sponsored entities (GSEs).	20% .....	20% on exposures other than equity exposures.	
	100% on GSE preferred stock (20% for national banks).	.....	
Claims on U.S. depository institutions and National Credit Union Administration (NCUA)-insured credit unions.	20% .....	20% .....	Instruments included in the capital of the depository institution may be deducted (refer to Addendum 1 on the definition of capital) or treated under the equities section below.
	100% risk weight for an instrument included in the depository institution's regulatory capital	100% risk weight for an instrument included in the depository institution's regulatory capital (unless that instrument is an equity exposure or is deducted—see Addendum 1)	
Claims on U.S. public sector entities (PSEs).	20% for general obligations .....	20% for general obligations.	
	50% for revenue obligations .....	50% for revenue obligations.	
Industrial development bonds.	100% .....	100%.	
Claims on qualifying securities firms.	20% in general .....	100% .....	Instruments included in the capital of the securities firm may be deducted (refer to Addendum 1 on the definition of capital) or treated under the equities section below.
		See commercial loans and corporate exposures to financial companies section below.	
1-4 family loans .....	50% if first lien, prudently underwritten, owner occupied or rented, current or <90 days past due; 100% otherwise.	Category 1: 35%, 50%, 75%, 100% depending on LTV.	Category 1 is defined to include first-lien mortgage products that meet certain underwriting characteristics.
		Category 2: 100%, 150%, 200% depending on LTV.	Category 2 is defined to include junior-liens and mortgages that do not meet the category 1 criteria.

## COMPARISON OF CURRENT RULES VS. PROPOSAL—Continued

Category	Current risk weight (in general)	Proposal	Comments
1–4 family loans modified under Home Affordable Mortgage Program (HAMP).	50% and 100% The banking organization must use the same risk weight assigned to the loan prior to the modification so long as the loan continues to meet other applicable prudential criteria.	35% to 200% The banking organization must determine whether the modified terms make the loan a Category 1 or a Category 2 mortgage.	Under the proposal (as under current rules) HAMP loans are not treated as restructured loans.
Loans to builders secured by 1–4 family properties presold under firm contracts.	50% if the loan meets all criteria in the regulation; 100% if the contract is cancelled; 100% for loans not meeting the criteria.	50% if the loan meets all criteria in the regulation; 100% if the contract is cancelled; 100% for loans not meeting the criteria.	
Loans on multifamily properties.	50% if the loan meets all the criteria in the regulation; 100% otherwise.	50% if the loan meets all the criteria in the regulation; 100% otherwise.	
Corporate exposures .....	100%	100% ..... However, if the exposure is an instrument included in the capital of the financial company, deduction treatment may apply (see Appendix 1).	
High-volatility commercial real estate (HVCRE) loans.	100% .....	150% .....	The proposed treatment would apply to certain facilities that finance the acquisition, development or construction of real property other than 1–4 family residential property.
Consumer loans .....	100% .....	100% .....	This is not a specific category under the proposal. Therefore the default risk weight of 100% applies.
Past due exposures .....	Generally the risk weight does not change when the loan is past due; However, 1–4 family loans that are past due 90 days or more are 100% risk weight.	150% for the portion that is not guaranteed or secured (does not apply to sovereign exposures or 1–4 family residential mortgage exposures).	
Assets not assigned to a risk weight category, including fixed assets, premises, and other real estate owned.	100% .....	100%	
Claims on foreign governments and their central banks.	0% for direct and unconditional claims on Organization for Economic Co-operation and Development (OECD) governments; 20% for conditional claims on OECD governments; 100% for claims on non-OECD governments that entail some degree of transfer risk.	Risk weight depends on Country Risk Classification (CRC) applicable to the sovereign and ranges between 0% and 150%; 100% for sovereigns that do not have a CRC; 150% for a sovereign that has defaulted within the previous 5 years.	Under the current and proposed rules, a banking organization may apply a lower risk weight to an exposure denominated in the sovereign's own currency if the banking organization has at least an equivalent amount of liabilities in that currency.
Claims on foreign banks ..	20% for claims on banks in OECD countries; 20% for short-term claims on banks in non-OECD countries; 100% for long-term claims on banks in non-OECD countries.	Risk weight depends on home country's CRC rating and ranges between 20% and 50%; 100% for foreign bank whose home country does not have a CRC; 150% in the case of a sovereign default in the bank's home country; 100% for an instrument included in a bank's regulatory capital (unless that instrument is an equity exposure or is deducted (see Addendum 1)).	Under the proposed rule, instruments included in the capital of a foreign bank would be deducted (refer to Addendum 1 on the definition of capital) or treated under the equities section below.
Claims on foreign PSEs ..	20% for general obligations of states and political subdivisions of OECD countries; 50% for revenue obligations of states and political subdivisions of OECD countries; 100% for all obligations of states and political subdivisions of non-OECD countries.	Risk weight depends on the home country's CRC and ranges between 20% and 150% for general obligations; and between 50% and 150% for revenue obligations; 100% for exposures to a PSE in a home country that does not have a CRC; 150% for a PSE in a home country with a sovereign default.	

COMPARISON OF CURRENT RULES VS. PROPOSAL—Continued

Category	Current risk weight (in general)	Proposal	Comments
<p>Mortgage backed security (MBS), asset backed security (ABS), and structured securities.</p>	<p><i>Ratings Based Approach:</i> .....                      —20%: AAA&amp;AA;                      —50%: A-rated                      —100%: BBB                      —200%: BB-rated                      [Securitizations with short-term ratings—20, 50, 100, and for unrated positions, where the banking organization determines the credit rating—100 or 200];  <i>Gross-up approach</i> the risk-weighted asset amount is calculated using the risk weight of the underlying assets amount of the position and the full amount of the assets supported by the position (that is, all of the more senior positions);                      Dollar for dollar capital for residual interests;                      Deduction for CEIO strips over concentration limit;                      100% for stripped MBS (interest only (IOs) and [FULL TERM] (Pos)) that are not credit enhancing.</p>	<p>Deduction for the after-tax gain-on-sale of a securitization;                      1,250% risk weight for a Credit-Enhancing Interest-Only Strip (CEIO);                      100% for interest-only MBS that are not credit-enhancing;                      Banking organizations may elect to follow a gross up approach, similar to existing rules.   <i>Simplified Supervisory Formula Approach (SSFA)</i>—the risk weight for a position is determined by a formula and is based on the risk weight applicable to the underlying exposures, the relative position of the securitization position in the structure (subordination), and measures of delinquency and loss on the securitized assets;                      1250% otherwise.</p>	
<p>Unsettled transactions .....</p>	<p>Not addressed.</p>	<p>100%, 625%, 937.5%, and 1,250% for DvP or PvP transactions depending on the number of business days past the settlement date;                      1,250% for non-DvP, non-PvP transactions more than 5 days past the settlement date.                      The proposed capital requirement for unsettled transactions would not apply to cleared transactions that are marked-to-market daily and subject to daily receipt and payment of variation margin.</p>	<p>DvP (delivery vs. payment) and PvP (payment vs. payment) are defined below.</p>
<p>Equity exposures .....</p>	<p>100% or incremental deduction approach for nonfinancial equity investments.</p>	<p>0% risk weight: equity exposures to a sovereign, certain supranational entities, or an MDB whose debt exposures are eligible for 0% risk weight;                      20%: Equity exposures to a PSE, a FHLB, or Farmer Mac;                      100%: Equity exposures to community development investments and small business investment companies and non-significant equity investments;                      250%: Significant investments in the capital of unconsolidated financial institutions that are not deducted from capital pursuant to section 22;                      300%: Most publicly-traded equity exposures;                      400%: Equity exposures that are not publicly-traded;                      600%: Equity exposures to certain investment funds.</p>	<p>MDB = multilateral development bank.</p>

## COMPARISON OF CURRENT RULES VS. PROPOSAL—Continued

Category	Current risk weight (in general)	Proposal	Comments
Equity exposures to investment funds.	<p>There is a 20% risk weight floor on mutual fund holdings.</p> <p>General rule: Risk weight is the same as the highest risk weight investment the fund is permitted to hold.</p> <p>Option: A banking organization may assign risk weights pro rata according to the investment limits in the fund's prospectus.</p>	<p><i>Full look-through:</i> Risk weight the assets of the fund (as if owned directly) <i>multiplied by</i> the banking organization's proportional ownership in the fund.</p> <p><i>Simple modified look-through:</i> Multiply the banking organization's exposure by the risk weight of the highest risk weight asset in the fund.</p> <p><i>Alternative modified look-through:</i> Assign risk weight on a pro rata basis based on the investment limits in the fund's prospectus.</p> <p>For community development exposures, risk-weighted asset amount = adjusted carrying value.</p>	

## Credit Conversion Factors Under the Current and Proposed Rules

Conversion factors for off-balance sheet items.	<p>0% for the unused portion of a commitment with an original maturity of one year or less, or which unconditionally cancellable at any time;</p> <p>10% for unused portions of eligible Asset-Backed Commercial Paper (ABCP) liquidity facilities with an original maturity of one year or less;</p> <p>20% for self-liquidating trade-related contingent items;</p> <p>50% for the unused portion of a commitment with an original maturity of more than one year that are not unconditionally cancellable;</p> <p>50% for transaction-related contingent items (performance bonds, bid bonds, warranties, and standby letters of credit);</p> <p>100% for guarantees, repurchase agreements, securities lending and borrowing transactions, financial standby letters of credit, and forward agreements.</p>	<p>0% for the unused portion of a commitment that is unconditionally cancellable by the banking organization;</p> <p>20% for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable;</p> <p>20% for self-liquidating, trade-related contingent items;</p> <p>50% for the unused portion of a commitment over one year that are not unconditionally cancellable;</p> <p>50% for transaction-related contingent items (performance bonds, bid bonds, warranties, and standby letters of credit);</p> <p>100% for guarantees, repurchase agreements, securities lending and borrowing transactions, financial standby letters of credit, and forward agreements.</p>	
Derivative contracts .....	Conversion to an on-balance sheet amount based on current exposure plus potential future exposure and a set of conversion factors. <i>50% risk weight cap.</i>	Conversion to an on-balance sheet amount based on current exposure plus potential future exposure and a set of conversion factors. <i>No risk weight cap.</i>	

COMPARISON OF CURRENT RULES VS. PROPOSAL—Continued

Category	Current risk weight (in general)	Proposal	Comments
<b>Credit Risk Mitigation Under the Current and Proposed Rules</b>			
Guarantees .....	<p>Generally recognizes guarantees provided by central governments, GSEs, public sector entities (PSEs) in OECD countries, multilateral lending institutions, regional development banking organizations, U.S. depository institutions, foreign banks, and qualifying securities firms in OECD countries.</p> <p>Substitution approach that allows the banking organization to substitute the risk weight of the protection provider for the risk weight ordinarily assigned to the exposure.</p>	<p>Recognizes guarantees from eligible guarantors: sovereign entities, Bank for International Settlements (BIS), International Monetary Fund (IMF), European Central Bank (ECB), European Commission, Federal Home Loan Banks (FHLBs), Farmer Mac, a multilateral development bank, a depository institution, a bank holding company, a savings and loan holding company, a foreign bank, or an entity other than a special purpose entity (SPE) that has investment grade debt, whose creditworthiness is not positively correlated with the credit risk of the exposures for which it provides guarantees and is not a monoline insurer or re-insurer.</p> <p>Substitution treatment allows the banking organization to substitute the risk weight of the protection provider for the risk weight ordinarily assigned to the exposure. Applies only to eligible guarantees and eligible credit derivatives, and adjusts for maturity mismatches, currency mismatches, and where restructuring is not treated as a credit event.</p>	<p>Claims conditionally guaranteed by the U.S. government receive a risk weight of 20 percent under the standardized approach.</p>
Collateralized transactions	<p>Recognize only cash on deposit, securities issued or guaranteed by OECD countries, securities issued or guaranteed by the U.S. government or a U.S. government agency, and securities issued by certain multilateral development banks.</p> <p>Substitute risk weight of collateral for risk weight of exposure, sometimes with a 20% risk weight floor.</p>	<p>For financial collateral only, the proposal provides two approaches:</p> <ol style="list-style-type: none"> <li>1. <i>Simple approach</i>: A banking organization may apply a risk weight to the portion of an exposure that is secured by the market value of collateral by using the risk weight of the collateral—with a general risk weight floor of 20%.</li> <li>2. <i>Collateral haircut approach</i> using standard supervisory haircuts or own estimates of haircuts for eligible margin loans, repo-style transactions, collateralized derivative contracts.</li> </ol>	<p><i>Financial collateral</i>: cash on deposit at the banking organization (or 3rd party custodian); gold; investment grade securities (excluding resecuritizations); publicly-traded equity securities; publicly-traded convertible bonds; money market mutual fund shares; and other mutual fund shares if a price is quoted daily. In all cases the banking organization must have a perfected, 1st priority interest.</p> <p>For the simple approach there must be a collateral agreement for at least the life of the exposure; collateral must be revalued at least every 6 months; collateral other than gold must be in the same currency.</p>

**Addendum 2: Definitions used in the Proposal**

Definitions of the terms used in this proposal can be found in Part [ ] CAPITAL ADEQUACY OF [BANK]s, Subpart A-General, Text § \_\_.2 Definitions, of the related document entitled “Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action” immediately preceding this proposal and published elsewhere in today’s **Federal Register**.

**Text of Proposed Common Rule**

**PART CAPITAL ADEQUACY OF [BANK]s**

**Subpart D—Risk-Weighted Assets—Standardized Approach**

Sec.

\_\_\_.30 Applicability.

**RISK-WEIGHTED ASSETS FOR GENERAL CREDIT RISK**

\_\_\_.31 Mechanics for calculating risk-weighted assets for general credit risk.

\_\_\_.32 General risk weights.

\_\_\_.33 Off-balance sheet exposures.

\_\_\_.34 OTC derivative contracts.

\_\_\_.35 Cleared transactions.

\_\_\_.36 Guarantees and credit derivatives: substitution treatment.

\_\_\_.37 Collateralized transactions.

**RISK-WEIGHTED ASSETS FOR UNSETTLED TRANSACTIONS**

\_\_\_.38 Unsettled transactions.

**RISK-WEIGHTED ASSETS FOR SECURITIZATION EXPOSURES**

- \_\_\_41 Operational requirements for securitization exposures.
- \_\_\_42 Risk-weighted assets for securitization exposures.
- \_\_\_43 Simplified supervisory formula approach (SSFA) and the gross-up approach.
- \_\_\_44 Securitization exposures to which the SSFA and gross-Up approach do not apply.
- \_\_\_45 Recognition of credit risk mitigants for securitization exposures.

**RISK-WEIGHTED ASSETS FOR EQUITY EXPOSURES**

- \_\_\_51 Introduction and exposure measurement.
- \_\_\_52 Simple risk-weight approach (SRWA).
- \_\_\_53 Equity exposures to investment funds.

**DISCLOSURES**

- \_\_\_61 Purpose and scope.
- \_\_\_62 Disclosure requirements.
- \_\_\_63 Disclosures by [BANK]s described in § \_\_\_.61.

**Subpart D—Risk Weighted Assets—Standardized Approach**

§ \_\_\_.30 Applicability.

(a) A market risk [BANK] must exclude from its calculation of risk-weighted assets under this subpart the risk-weighted asset amounts of all covered positions, as defined in subpart F of this part (except foreign exchange positions that are not trading positions, over-the-counter (OTC) derivative positions, cleared transactions, and unsettled transactions).

(b) On January 1, 2015, and thereafter, a [BANK] must calculate risk-weighted assets under subpart D of this part. On or before December 31, 2014, the [BANK] must calculate risk-weighted assets under either:

- (i) The methodology described in the general risk-based capital rules under 12 CFR part 3, appendix A, 12 CFR part 167 (OCC); 12 CFR part 208, appendix A, 12 CFR part 225, appendix A (Board); 12 CFR part 325, appendix A, and 12 CFR part 390 (FDIC); or
  - (ii) Subpart D of this part.
- (c) Notwithstanding paragraph (b) of this section, a [BANK] is subject to the transition provisions under § \_\_\_.300.

**RISK-WEIGHTED ASSETS FOR GENERAL CREDIT RISK**

§ \_\_\_.31 Mechanics for calculating risk-weighted assets for general credit risk.

(a) *General risk-weighting requirements.* A [BANK] must apply risk weights to its exposures as follows:

- (1) A [BANK] must determine the exposure amount of each on-balance sheet exposure, each OTC derivative contract, and each off-balance sheet commitment, trade and transaction-related contingency, guarantee, repo-style transaction, financial standby letter of credit, forward agreement, or other similar transaction that is not:
  - (i) An unsettled transaction subject to § \_\_\_.38;
  - (ii) A cleared transaction subject to § \_\_\_.35;
  - (iii) A default fund contribution subject to § \_\_\_.35;
  - (iv) A securitization exposure subject to §§ \_\_\_.41 through \_\_\_.45; or

(v) An equity exposure (other than an equity OTC derivative contract) subject to §§ \_\_\_.51 through \_\_\_.53.

(2) The [BANK] must multiply each exposure amount by the risk weight appropriate to the exposure based on the exposure type or counterparty, eligible guarantor, or financial collateral to determine the risk-weighted asset amount for each exposure.

(b) Total risk-weighted assets for general credit risk equals the sum of the risk-weighted asset amounts calculated under this section.

§ \_\_\_.32 General risk weights.

(a) *Sovereign exposures.* (1) *Exposures to the U.S. government.* (i) Notwithstanding any other requirement in this subpart, a [BANK] must assign a zero percent risk weight to:

(A) An exposure to the U.S. government, its central bank, or a U.S. government agency; and

(B) The portion of an exposure that is directly and unconditionally guaranteed by the U.S. government, its central bank, or a U.S. government agency.<sup>95</sup>

(ii) A [BANK] must assign a 20 percent risk weight to the portion of an exposure that is conditionally guaranteed by the U.S. government, its central bank, or a U.S. government agency.

(2) *Other sovereign exposures.* A [BANK] must assign a risk weight to a sovereign exposure based on the Country Risk Classification (CRC) applicable to the sovereign in accordance with Table 1.

TABLE 1—RISK WEIGHTS FOR SOVEREIGN EXPOSURES

		Risk weight (in person)
Sovereign CRC .....	0–1	0
	2	20
	3	50
	4–6	100
	7	150
No CRC		100
Sovereign Default		150

(3) *Certain sovereign exposures.* Notwithstanding paragraph (a)(2) of this section, a [BANK] may assign to a sovereign exposure a risk weight that is lower than the applicable risk weight in Table 1 if:

(i) The exposure is denominated in the sovereign’s currency;

(ii) The [BANK] has at least an equivalent amount of liabilities in that currency; and

(iii) The risk weight is not lower than the risk weight that the sovereign allows [BANK]s under its jurisdiction to assign to the same exposures to the sovereign.

(4) *Sovereign exposures with no CRC.* Except as provided in paragraph (a)(5) of this section, a [BANK] must assign a 100 percent risk weight to a sovereign exposure if the sovereign does not have a CRC assigned to it.

(5) *Sovereign default.* A [BANK] must assign a 150 percent risk weight to a

<sup>95</sup> Under this section, a [BANK] must assign a zero percent risk weight to a deposit, or the portion

of a deposit, that is insured by the FDIC or National Credit Union Administration.

sovereign exposure immediately upon determining that an event of sovereign default has occurred, or if an event of sovereign default has occurred during the previous five years.

(b) *Certain supranational entities and Multilateral Development Banks (MDBs)*. A [BANK] must assign a zero percent risk weight to an exposure to the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, or an MDB.

(c) *Exposures to government-sponsored entities (GSEs)*. (1) A [BANK] must assign a 20 percent risk weight to an exposure to a GSE that is not an equity exposure.

(2) A [BANK] must assign a 100 percent risk weight to preferred stock issued by a GSE.

(d) *Exposures to depository institutions, foreign banks, and credit unions*. (1) *Exposures to U.S. depository institutions and credit unions*. A [BANK] must assign a 20 percent risk weight to an exposure to a depository institution or credit union that is organized under the laws of the United States or any state thereof, except as otherwise provided under paragraph (d)(3) of this section.

(2) *Exposures to foreign banks*. (i) Except as otherwise provided under paragraphs (d)(2)(ii) and (d)(3) of this section, a [BANK] must assign a risk weight to an exposure to a foreign bank using the CRC rating that corresponds to the foreign bank's home country in accordance with Table 2.

TABLE 2—RISK WEIGHTS FOR EXPOSURES TO FOREIGN BANKS

	Risk weight (in percent)
Sovereign CRC:	
0–1 .....	20
2 .....	50
3 .....	100
4–7 .....	150
No CRC .....	100
Sovereign Default .....	150

(ii) A [BANK] must assign a 100 percent risk weight to an exposure to a foreign bank whose home country does not have a CRC, with the exception of self-liquidating, trade-related contingent items that arise from the movement of goods, and that have a maturity of three months or less, which may be assigned a 20 percent risk weight.

(iii) A [BANK] must assign a 150 percent risk weight to an exposure to a foreign bank immediately upon determining that an event of sovereign default has occurred in the bank's home country, or if an event of sovereign

default has occurred in the foreign bank's home country during the previous five years.

(3) A [BANK] must assign a 100 percent risk weight to an exposure to a financial institution that is includable in that financial institution's capital unless the exposure is:

(i) An equity exposure;

(ii) A significant investment in the capital of an unconsolidated financial institution in the form of common stock pursuant to § .22(d)(iii);

(iii) Is deducted from regulatory capital under § .22 of the proposal; and

(iv) Subject to a 150 percent risk weight under Table 2 of paragraph (d)(2) of this section.

(e) *Exposures to public sector entities (PSEs)*. (1) *Exposures to U.S. PSEs*. (i) A [BANK] must assign a 20 percent risk weight to a general obligation exposure to a PSE that is organized under the laws of the United States or any state or political subdivision thereof.

(ii) A [BANK] must assign a 50 percent risk weight to a revenue obligation exposure to a PSE that is organized under the laws of the United States or any state or political subdivision thereof.

(2) *Exposures to foreign PSEs*. (i) Except as provided in paragraphs (e)(1) and (e)(3) of this section, a [BANK] must assign a risk weight to a general obligation exposure to a PSE based on the CRC that corresponds to the PSE's home country, as set forth in Table 3.

(ii) Except as provided in paragraphs (e)(1) and (e)(3) of this section, a [BANK] must assign a risk weight to a revenue obligation exposure to a PSE based on the CRC that corresponds to the PSE's home country, as set forth in Table 4.

(3) A [BANK] may assign a lower risk weight than would otherwise apply under Table 3 and 4 to an exposure to a foreign PSE if:

(i) The PSE's home country allows banks under its jurisdiction to assign a lower risk weight to such exposures; and

(ii) The risk weight is not lower than the risk weight that corresponds to the PSE's home country in accordance with Table 1.

TABLE 3—RISK WEIGHTS FOR NON-U.S. PSE GENERAL OBLIGATIONS

	Risk weight (in percent)
Sovereign CRC:	
0–1 .....	20
2 .....	50
3 .....	100

TABLE 3—RISK WEIGHTS FOR NON-U.S. PSE GENERAL OBLIGATIONS—Continued

	Risk weight (in percent)
4–7 .....	150
No CRC .....	100
Sovereign Default .....	150

TABLE 4—RISK WEIGHTS FOR NON-U.S. PSE REVENUE OBLIGATIONS

	Risk weight (in percent)
Sovereign CRC:	
0–1 .....	20
2–3 .....	100
4–7 .....	150
No CRC .....	100
Sovereign Default .....	150

(4) A [BANK] must assign a 100 percent risk weight to an exposure to a PSE whose home country does not have a CRC.

(5) A [BANK] must assign a 150 percent risk weight to a PSE exposure immediately upon determining that an event of sovereign default has occurred in a PSE's home country or if an event of sovereign default has occurred in the PSE's home country during the previous five years.

(f) *Corporate exposures*. A [BANK] must assign a 100 percent risk weight to all its corporate exposures.

(g) *Residential mortgage exposures*. (1) *General Requirement*. A [BANK] must assign to a residential mortgage exposure the applicable risk weight in Table 6, using the loan-to-value (LTV) ratio described in paragraph (g)(3) of this section.

(2) *Restructured or modified mortgages*. (i) If a residential mortgage exposure is restructured or modified, the [BANK] must classify the residential mortgage exposure as a category 1 residential mortgage exposure or category 2 residential mortgage exposure in accordance with the terms and characteristics of the exposure after the modification or restructuring.

(ii) A [BANK] may assign a risk weight lower than 100 percent to a category 1 residential mortgage exposure after the exposure has been modified or restructured only if:

(A) The residential mortgage exposure continues to meet category 1 criteria; and

(B) The [BANK] updates the LTV ratio at the time of restructuring, as provided under paragraph (g)(3) of this section.

(iii) A [BANK] may assign a risk weight lower than 200 percent to a category 2 residential mortgage



exposure after the exposure has been modified or restructured only if the [BANK] updates the LTV ratio at the

time of restructuring as provided under paragraphs (g)(3) of this section.

TABLE 6—RISK WEIGHTS FOR RESIDENTIAL MORTGAGE EXPOSURES

Loan-to-value ratio (in percent)	Category 1 residential mortgage exposure (in percent)	Category 2 residential mortgage exposure (in 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

(3) *LTV ratio calculation.* To determine the LTV ratio of a residential mortgage loan for the purpose of this section, a [BANK] must divide the loan amount by the value of the property, as described in this section. A [BANK] must assign a risk weight to the exposure according to its respective LTV ratio.

(i) *Loan amount for calculating the LTV ratio of a residential mortgage exposure.* (A) *First-lien residential mortgage exposure.* The loan amount of a first-lien residential mortgage exposure is the unpaid principal balance of the loan. If the first-lien residential mortgage exposure is a combination of a first and junior lien, the loan amount is the maximum contractual principal amount of the exposure.

(B) *Junior-lien residential mortgage exposure.* The loan amount of a junior-lien residential mortgage exposure is the maximum contractual principal amount of the exposure, plus the maximum contractual principal amounts of all senior exposures secured by the same residential property on the date of origination of the junior-lien residential mortgage exposure.

(ii) *Value.* (A) The value of the property is the lesser of the actual acquisition cost (for a purchase transaction) or the estimate of the property's value at the origination of the loan or at the time of restructuring or modification.

(B) A [BANK] must base all estimates of a property's value on an appraisal or evaluation of the property that satisfies 12 CFR part 34, subpart C, 12 CFR part 164 (OCC); 12 CFR part 208, subpart E (Board); 12 CFR part 323, 12 CFR 390.442 (FDIC).

(4) *Loans modified pursuant to the Home Affordable Mortgage Program.* A loan modified or restructured on a permanent or trial basis solely pursuant to the U.S. Treasury's Home Affordable Mortgage Program is not modified or restructured for purposes of this section.

(h) *Pre-sold residential construction loans.* A [BANK] must assign a 50

percent risk weight to a pre-sold construction loan unless the purchase contract is cancelled. A [BANK] must assign a 100 percent risk weight to such loan if the purchase contract is cancelled.

(i) *Statutory multifamily mortgages.* A [BANK] must assign a 50 percent risk weight to a statutory multifamily mortgage.

(j) *High-volatility commercial real estate (HVCRE) exposures.* A [BANK] must assign a 150 percent risk weight to an HVCRE exposure.

(k) *Past due exposures.* Except for a sovereign exposure or a residential mortgage exposure, if an exposure is 90 days or more past due or on nonaccrual:

(1) A [BANK] must assign a 150 percent risk weight to the portion of the exposure that is not guaranteed or that is unsecured.

(2) A [BANK] may assign a risk weight to the collateralized portion of a past due exposure based on the risk weight that applies under § \_\_\_\_.37 if the collateral meets the requirements of that section.

(3) A [BANK] may assign a risk weight to the guaranteed portion of a past due exposure based on the risk weight that applies under § \_\_\_\_.36 if the guarantee or credit derivative meets the requirements of that section.

(l) *Other assets.* (1) A [BANK] must assign a zero percent risk weight to cash owned and held in all offices of the [BANK] or in transit; to gold bullion held in the [BANK]'s own vaults or held in another depository institution's vaults on an allocated basis, to the extent the gold bullion assets are offset by gold bullion liabilities; and to exposures that arise from the settlement of cash transactions (such as equities, fixed income, spot FX and spot commodities) with a central counterparty where there is no assumption of ongoing counterparty credit risk by the central counterparty after settlement of the trade and associated default fund contributions.

(2) A [BANK] must assign a 20 percent risk weight to cash items in the process of collection.

(3) A [BANK] must assign a 100 percent risk weight to DTAs arising from temporary differences that the [BANK] could realize through net operating loss carrybacks.

(4) A [BANK] must assign a 250 percent risk weight to MSAs and DTAs arising from temporary differences that the [BANK] could not realize through net operating loss carrybacks that are not deducted from common equity tier 1 capital pursuant to § \_\_\_\_.22(d).

(5) A [BANK] must assign a 100 percent risk weight to all assets not specifically assigned a different risk weight under this subpart (other than exposures that are deducted from tier 1 or tier 2 capital).

(6) Notwithstanding the requirements of this section, a [BANK] may assign an asset that is not included in one of the categories provided in this section to the risk weight category applicable under the capital rules applicable to bank holding companies and savings and loan holding companies at 12 CFR part 217, provided that all of the following conditions apply:

(i) The [BANK] is not authorized to hold the asset under applicable law other than debt previously contracted or similar authority; and

(ii) The risks associated with the asset are substantially similar to the risks of assets that are otherwise assigned to a risk weight category of less than 100 percent under this subpart.

#### § \_\_\_\_.33 Off-balance sheet exposures.

(a) *General.* (1) A [BANK] must calculate the exposure amount of an off-balance sheet exposure using the credit conversion factors (CCFs) in paragraph (b) of this section.

(2) Where a [BANK] commits to provide a commitment, the [BANK] may apply the lower of the two applicable CCFs.

(3) Where a [BANK] provides a commitment structured as a syndication or participation, the [BANK] is only

required to calculate the exposure amount for its pro rata share of the commitment.

(b) *Credit conversion factors.* (1) *Zero percent CCF.* A [BANK] must apply a zero percent CCF to the unused portion of commitments that are unconditionally cancelable by the [BANK].

(2) *20 percent CCF.* A [BANK] must apply a 20 percent CCF to:

(i) Commitments with an original maturity of one year or less that are not unconditionally cancelable by the [BANK].

(ii) Self-liquidating, trade-related contingent items that arise from the movement of goods, with an original maturity of one year or less.

(3) *50 percent CCF.* A [BANK] must apply a 50 percent CCF to:

(i) Commitments with an original maturity of more than one year that are not unconditionally cancelable by the [BANK].

(ii) Transaction-related contingent items, including performance bonds, bid bonds, warranties, and performance standby letters of credit.

(4) *100 percent CCF.* A [BANK] must apply a 100 percent CCF to the following off-balance-sheet items and other similar transactions:

(i) Guarantees;

(ii) Repurchase agreements (the off-balance sheet component of which

equals the sum of the current market values of all positions the [BANK] has sold subject to repurchase);

(iii) Off-balance sheet securities lending transactions (the off-balance sheet component of which equals the sum of the current market values of all positions the [BANK] has lent under the transaction);

(iv) Off-balance sheet securities borrowing transactions (the off-balance sheet component of which equals the sum of the current market values of all non-cash positions the [BANK] has posted as collateral under the transaction);

(v) Financial standby letters of credit; and

(vi) Forward agreements.

**§ .34 OTC derivative contracts.**

(a) *Exposure amount.* (1) *Single OTC derivative contract.* Except as modified by paragraph (b) of this section, the exposure amount for a single OTC derivative contract that is not subject to a qualifying master netting agreement is equal to the sum of the [BANK]'s current credit exposure and potential future credit exposure (PFE) on the OTC derivative contract.

(i) *Current credit exposure.* The current credit exposure for a single OTC derivative contract is the greater of the mark-to-market value of the OTC derivative contract or zero.

(ii) *PFE.* (A) The PFE for a single OTC derivative contract, including an OTC derivative contract with a negative mark-to-market value, is calculated by multiplying the notional principal amount of the OTC derivative contract by the appropriate conversion factor in Table 7.

(B) For purposes of calculating either the PFE under this paragraph or the gross PFE under paragraph (a)(2) of this section for exchange rate contracts and other similar contracts in which the notional principal amount is equivalent to the cash flows, notional principal amount is the net receipts to each party falling due on each value date in each currency.

(C) For an OTC derivative contract that does not fall within one of the specified categories in Table 7, the PFE must be calculated using the appropriate "other" conversion factor.

(D) A [BANK] must use an OTC derivative contract's effective notional principal amount (that is, the apparent or stated notional principal amount multiplied by any multiplier in the OTC derivative contract) rather than the apparent or stated notional principal amount in calculating PFE.

(E) The PFE of the protection provider of a credit derivative is capped at the net present value of the amount of unpaid premiums.

TABLE 7—CONVERSION FACTOR MATRIX FOR DERIVATIVE CONTRACTS <sup>1</sup>

Remaining maturity <sup>2</sup>	Interest rate	Foreign exchange rate and gold	Credit (investment-grade reference asset) <sup>3</sup>	Credit (non-investment-grade reference asset)	Equity	Precious metals (except gold)	Other
One year or less .....	0.00	0.01	0.05	0.10	0.06	0.07	0.10
Greater than one year and less than or equal to five years ....	0.005	0.05	0.05	0.10	0.08	0.07	0.12
Greater than five years	0.015	0.075	0.05	0.10	0.10	0.08	0.15

<sup>1</sup> For a derivative contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the derivative contract.

<sup>2</sup> For an OTC derivative contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the contract is zero, the remaining maturity equals the time until the next reset date. For an interest rate derivative contract with a remaining maturity of greater than one year that meets these criteria, the minimum conversion factor is 0.005.

<sup>3</sup> A [BANK] must use the column labeled "Credit (investment-grade reference asset)" for a credit derivative whose reference asset is an outstanding unsecured long-term debt security without credit enhancement that is investment grade. A [BANK] must use the column labeled "Credit (non-investment-grade reference asset)" for all other credit derivatives.

(2) *Multiple OTC derivative contracts subject to a qualifying master netting agreement.* Except as modified by paragraph (b) of this section, the exposure amount for multiple OTC derivative contracts subject to a qualifying master netting agreement is equal to the sum of the net current credit exposure and the adjusted sum of the PFE amounts for all OTC derivative contracts subject to the qualifying master netting agreement.

(i) *Net current credit exposure.* The net current credit exposure is the greater of the net sum of all positive and negative mark-to-market values of the individual OTC derivative contracts subject to the qualifying master netting agreement or zero.

(ii) *Adjusted sum of the PFE amounts.* The adjusted sum of the PFE amounts, *Anet*, is calculated as  $Anet = (0.4 \times Agross) + (0.6 \times NGR \times Agross)$ , where:

(A) *Agross* = the gross PFE (that is, the sum of the PFE amounts (as determined under paragraph (a)(1)(ii) of this section for each individual derivative contract subject to the qualifying master netting agreement); and

(B) *Net-to-gross Ratio (NGR)* = the net to gross ratio (that is, the ratio of the net current credit exposure to the gross current credit exposure). In calculating the NGR, the gross current credit exposure equals the sum of the positive

current credit exposures (as determined under paragraph (a)(1)(i) of this section) of all individual derivative contracts subject to the qualifying master netting agreement).

(b) *Recognition of credit risk mitigation of collateralized OTC derivative contracts.* (1) A [BANK] may recognize the credit risk mitigation benefits of financial collateral that secures an OTC derivative contract or multiple OTC derivative contracts subject to a qualifying master netting agreement (netting set) by using the simple approach in § \_\_\_\_.37(b).

(2) As an alternative to the simple approach, a [BANK] may recognize the credit risk mitigation benefits of financial collateral that secures such a contract or netting set if the financial collateral is marked-to-market on a daily basis and subject to a daily margin maintenance requirement by applying a risk weight to the exposure as if it is uncollateralized and adjusting the exposure amount calculated under paragraph (a)(1)(i) or (ii) of this section using the collateral haircut approach in § \_\_\_\_.37(c). The [BANK] must substitute the exposure amount calculated under paragraph (a)(1)(i) or (ii) of this section for  $\Sigma E$  in the equation in § \_\_\_\_.37(c)(2).

(c) *Counterparty credit risk for OTC credit derivatives.* (1) *Protection purchasers.* A [BANK] that purchases an OTC credit derivative that is recognized under § \_\_\_\_.36 as a credit risk mitigant for an exposure that is not a covered position under subpart F is not required to compute a separate counterparty credit risk capital requirement under § \_\_\_\_.32 provided that the [BANK] does so consistently for all such credit derivatives. The [BANK] must either include all or exclude all such credit derivatives that are subject to a qualifying master netting agreement from any measure used to determine counterparty credit risk exposure to all relevant counterparties for risk-based capital purposes.

(2) *Protection providers.* (i) A [BANK] that is the protection provider under an OTC credit derivative must treat the OTC credit derivative as an exposure to the underlying reference asset. The [BANK] is not required to compute a counterparty credit risk capital requirement for the OTC credit derivative under § \_\_\_\_.32, provided that this treatment is applied consistently for all such OTC credit derivatives. The [BANK] must either include all or exclude all such OTC credit derivatives that are subject to a qualifying master netting agreement from any measure used to determine counterparty credit risk exposure.

(ii) The provisions of paragraph (c)(2) of this section apply to all relevant counterparties for risk-based capital purposes unless the [BANK] is treating the OTC credit derivative as a covered position under subpart F, in which case the [BANK] must compute a supplemental counterparty credit risk capital requirement under this section.

(d) *Counterparty credit risk for OTC equity derivatives.* (1) A [BANK] must treat an OTC equity derivative contract as an equity exposure and compute a risk-weighted asset amount for the OTC equity derivative contract under §§ \_\_\_\_.51 through \_\_\_\_.53 (unless the [BANK] is treating the contract as a covered position under subpart F).

(2) In addition, the [BANK] must also calculate a risk-based capital requirement for the counterparty credit risk of an OTC equity derivative contract under this section if the [BANK] is treating the contract as a covered position under subpart F.

(3) If the [BANK] risk weights the contract under the Simple Risk-Weight Approach (SRWA) in § \_\_\_\_.52, the [BANK] may choose not to hold risk-based capital against the counterparty credit risk of the OTC equity derivative contract, as long as it does so for all such contracts. Where the OTC equity derivative contracts are subject to a qualified master netting agreement, a [BANK] using the SRWA must either include all or exclude all of the contracts from any measure used to determine counterparty credit risk exposure.

### § \_\_\_\_. 35 Cleared transactions.

(a) *Requirements.* (1) A [BANK] that is a clearing member client must use the methodologies described in paragraph (b) of this section to calculate risk-weighted assets for a cleared transaction.

(2) A [BANK] that is a clearing member must use the methodologies described in paragraph (c) of this section to calculate its risk-weighted assets for cleared transactions and paragraph (d) of this section to calculate its risk-weighted assets for its default fund contribution to a CCP.

(b) *Clearing member client [BANK]s.* (1) *Risk-weighted assets for cleared transactions.* (i) To determine the risk-weighted asset amount for a cleared transaction, a [BANK] that is a clearing member client must multiply the trade exposure amount for the cleared transaction, calculated in accordance with paragraph (b)(2) of this section, by the risk weight appropriate for the cleared transaction, determined in accordance with paragraph (b)(3) of this section.

(ii) A clearing member client [BANK]'s total risk-weighted assets for cleared transactions is the sum of the risk-weighted asset amounts for all its cleared transactions.

(2) *Trade exposure amount.* (i) For a cleared transaction that is a derivative contract or netting set of derivative contracts, the trade exposure amount equals:

(A) The exposure amount for the derivative contract or netting set of derivative contracts, calculated using the methodology used to calculate exposure amount for OTC derivative contracts under § \_\_\_\_.34, plus

(B) The fair value of the collateral posted by the clearing member client [BANK] and held by the CCP or a clearing member in a manner that is not bankruptcy remote.

(ii) For a cleared transaction that is a repo-style transaction, the trade exposure amount equals:

(A) The exposure amount for the repo-style transaction calculated using the methodologies under § \_\_\_\_.37(c), plus

(B) The fair value of the collateral posted by the clearing member client and held by the CCP or a clearing member in a manner that is not bankruptcy remote.

(3) *Cleared transaction risk weights.*

(i) For a cleared transaction with a QCCP, a clearing member client [BANK] must apply a risk weight of:

(A) 2 percent if the collateral posted by the [BANK] to the QCCP or clearing member is subject to an arrangement that prevents any losses to the clearing member client due to the joint default or a concurrent insolvency, liquidation, or receivership proceeding of the clearing member and any other clearing member clients of the clearing member; and the clearing member client [BANK] has conducted sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review) that in the event of a legal challenge (including one resulting from default or from liquidation, insolvency, or receivership proceeding) the relevant court and administrative authorities would find the arrangements to be legal, valid, binding and enforceable under the law of the relevant jurisdictions; or

(B) 4 percent in all other circumstances.

(ii) For a cleared transaction with a CCP that is not a QCCP, a clearing member client [BANK] must apply the risk weight appropriate for the CCP according to § \_\_\_\_.32.

(4) *Collateral.* (i) Notwithstanding any other requirements in this section, collateral posted by a clearing member client [BANK] that is held by a

custodian in a manner that is bankruptcy remote from the CCP, clearing member and other clearing member clients of the clearing member, is not subject to a capital requirement under this section.

(ii) A [BANK] must calculate a risk-weighted asset amount for any collateral provided to a CCP, clearing member or a custodian in connection with a cleared transaction in accordance with the requirements under § \_\_\_\_.32.

(c) *Clearing member [BANK]s. (1) Risk-weighted assets for cleared transactions.* (i) To determine the risk-weighted asset amount for a cleared transaction, a clearing member [BANK] must multiply the trade exposure amount for the cleared transaction, calculated in accordance with paragraph (c)(2) of this section, by the risk weight appropriate for the cleared transaction, determined in accordance with paragraph (c)(3) of this section.

(ii) A clearing member [BANK]'s total risk-weighted assets for cleared transactions is the sum of the risk-weighted asset amounts for all of its cleared transactions.

(2) *Trade exposure amount.* A clearing member [BANK] must calculate its trade exposure amount for a cleared transaction as follows:

(i) For a derivative contract that is a cleared transaction, the trade exposure amount equals:

$$K_{CCP} = \sum_{\text{clearing member } i} \max (EBRM_i - VM_i - IM_i - DF_i; 0) \times RW \times 0.08$$

Where

(A)  $EBRM_i$  = the exposure amount for each transaction cleared through the QCCP by clearing member  $i$ , calculated in accordance with § \_\_\_\_.34 for derivative transactions and § \_\_\_\_.37(c)(2) for repo-style transactions, provided that:

(1) For purposes of this section, in calculating the exposure amount the [BANK] may replace the formula provided in § \_\_\_\_.34 with the following:  $Anet = (0.3 \times Agross) + (0.7 \times NGR \times Agross)$  or, if the [BANK] cannot calculate NGR, it may use a value of 0.30 until March 31, 2013; and

(2) For derivative contracts that are options, the PFE described in § \_\_\_\_.34(b)(2) must

(A) The exposure amount for the derivative contract, calculated using the methodology to calculate exposure amount for OTC derivative contracts under § \_\_\_\_.34, plus

(B) The fair value of the collateral posted by the clearing member [BANK] and held by the CCP in a manner that is not bankruptcy remote.

(ii) For a repo-style transaction that is a cleared transaction, trade exposure amount equals:

(A) The exposure amount for repo-style transactions calculated using methodologies under § \_\_\_\_.37(c), plus

(B) The fair value of the collateral posted by the clearing member [BANK] and held by the CCP in a manner that is not bankruptcy remote.

(3) *Cleared transaction risk weight.* (i) For a cleared transaction with a QCCP, a clearing member [BANK] must apply a risk weight of 2 percent.

(ii) For a cleared transaction with a CCP that is not a QCCP, a clearing member [BANK] must apply the risk weight appropriate for the CCP according to § \_\_\_\_.32.

(4) *Collateral.* (i) Notwithstanding any other requirement in this section, collateral posted by a clearing member [BANK] that is held by a custodian in a manner that is bankruptcy remote from the CCP is not subject to a capital requirement under this section.

(ii) A [BANK] must calculate a risk-weighted asset amount for any collateral provided to a CCP, clearing member or a custodian in connection with a cleared transaction in accordance with requirements under § \_\_\_\_.32.

(d) *Default fund contributions.* (1) *General requirement.* A clearing member [BANK] must determine the risk-weighted asset amount for a default fund contribution to a CCP at least quarterly, or more frequently if, in the opinion of the [BANK] or the [AGENCY], there is a material change in the financial condition of the CCP.

(2) *Risk-weighted asset amount for default fund contributions to non-qualifying CCPs.* A clearing member [BANK]'s risk-weighted asset amount for default fund contributions to CCPs that are not QCCPs equals the sum of such default fund contributions multiplied by 1,250 percent.

(3) *Risk-weighted asset amount for default fund contributions to QCCPs.* A clearing member [BANK]'s risk-weighted asset amount for default fund contributions to QCCPs equals the sum of its capital requirement,  $K_{CM}$  for each QCCP, as calculated under § \_\_\_\_.35(d)(3)(i), multiplied by 1,250 percent.

(i) The hypothetical capital requirement of a QCCP ( $K_{CCP}$ ) equals:

(A)  $EBRM_i$  = the exposure amount for each transaction cleared through the QCCP by clearing member  $i$ , calculated in accordance with § \_\_\_\_.34 for derivative transactions and § \_\_\_\_.37(c)(2) for repo-style transactions, provided that:

(B)  $VM_i$  = any collateral posted by clearing member  $i$  to the QCCP that it is entitled to receive from the QCCP, but has not yet received, and any collateral that the QCCP is entitled to receive from clearing member  $i$ , but has not yet received;

(C)  $IM_i$  = the collateral posted as initial margin by clearing member  $i$  to the QCCP;

(D)  $DF_i$  = the funded portion of clearing member  $i$ 's default fund contribution that will be applied to reduce the QCCP's loss upon a default by clearing member  $i$ ; and

(E)  $RW = 20$  percent, except when the [AGENCY] has determined that a higher risk weight is more appropriate based on the specific characteristics of the QCCP and its clearing members.

(ii) For a [BANK] that is a clearing member of a QCCP with a default fund supported by funded commitments,  $K_{CM}$  equals:

$$K_{CM_i} = \left( (1 + \beta) \cdot \frac{N}{N-2} \right) \cdot \frac{DF_i}{DF_{CM}} \cdot K_{CM}^*$$

$$K_{CM}^* = \begin{cases} c_2 \cdot \mu \cdot (K_{CCP} - DF') + c_2 \cdot DF_{CM}' & \text{if } DF' < K_{CCP} & (i) \\ c_2 \cdot (K_{CCP} - DF_{CCP}') + c_1 \cdot (DF' - K_{CCP}) & \text{if } DF_{CCP}' < K_{CCP} \leq DF' & (ii) \\ c_1 \cdot DF_{CM}' & \text{if } K_{CCP} \leq DF_{CCP}' & (iii) \end{cases}$$

Where

$$(A) \quad \beta = \frac{A_{Net,1} + A_{Net,2}}{\sum_i A_{Net,i}}$$

Subscripts 1 and 2 denote the clearing members with the two largest  $A_{Net}$  values. For purposes of this paragraph, for derivatives  $A_{Net}$  is defined in § \_\_\_\_\_.34(a)(2)(ii) and for repo-style transactions,  $A_{Net}$  means the exposure amount as defined in § \_\_\_\_\_.37(c)(2);

(B)  $N$  = the number of clearing members in the QCCP;

(C)  $DF_{CCP}'$  = the QCCP's own funds and other financial resources that would be used to cover its losses before clearing members' default fund contributions are used to cover losses;

(D)  $DF_{CM}$  = funded default fund contributions from all clearing members and any other clearing member contributed financial resources that are available to absorb mutualized QCCP losses;

(E)  $DF = DF_{CCP}' + DF_{CM}$  (that is, the total funded default fund contribution);

(F)  $\overline{DF}_i$  = average  $\overline{DF}_i$  = the average funded default fund contribution from an individual

clearing member;

(G)  $DF_{CM}' = DF_{CM} - 2 \cdot \overline{DF}_i = \sum_i DF_i - 2 \cdot \overline{DF}_i$  (that is, the funded default fund contribution

from surviving clearing members assuming that two average clearing

members have defaulted and their default fund contributions and initial

margins have been used to absorb the resulting losses);

(H)  $DF' = DF_{CCP} + DF_{CM} = DF - 2 \cdot \overline{DF}_i$  (that is, the total funded default fund contributions from the QCCP and the surviving clearing members that are available to mutualize losses, assuming that two average clearing members have defaulted);

$$(I) c_1 = \text{Max} \left\{ \frac{1.6\%}{(DF'/K_{CCP})^{0.3}}; 0.16\% \right\} \quad (\text{that is, a decreasing capital factor, between 0.16}$$

percent and 1.6 percent, applied to the excess funded default funds provided by clearing members);

(J)  $c_2 = 100$  percent; and

(K)  $\mu = 1.2$ ;

(iii) (A) For a [BANK] that is a clearing member of a QCCP with a default fund supported by unfunded commitments,  $K_{CM}$  equals:

$$K_{CM_i} = \frac{DF_i}{DF_{CM}} \cdot K_{CM}^*$$

Where

(1)  $DF_i$  = the [BANK]'s unfunded commitment to the default fund;

(2)  $DF_{CM}$  = the total of all clearing members' unfunded commitment to the default fund;

and

(3)  $K_{CM}^*$  as defined in paragraph (d)(3)(ii) of this section.

(B) For a [BANK] that is a clearing member of a QCCP with a default fund

supported by unfunded commitments and is unable to calculate  $K_{CM}$  using the

methodology described in paragraph (d)(3)(iii) of this section,  $K_{CM}$  equals:

$$K_{CM_i} = \frac{IM_i}{IM_{CM}} \cdot K_{CM}^*$$

Where

- (1)  $IM_i$  = the [BANK]'s initial margin posted to the QCCP;
- (2)  $IM_{CM}$  = the total of initial margin posted to the QCCP; and
- (3)  $K_{CM}^*$  as defined in paragraph (d)(3)(ii) of this section.

(4) *Total risk-weighted assets for default fund contributions.* Total risk-weighted assets for default fund contributions is the sum of a clearing member [BANK]'s risk-weighted assets for all of its default fund contributions to all CCPs of which the [BANK] is a clearing member.

**§ \_\_\_\_ .36 Guarantees and credit derivatives: substitution treatment.**

(a) *Scope.* (1) *General.* A [BANK] may recognize the credit risk mitigation benefits of an eligible guarantee or eligible credit derivative by substituting the risk weight associated with the protection provider for the risk weight assigned to an exposure, as provided under this section.

(2) This section applies to exposures for which:

- (i) Credit risk is fully covered by an eligible guarantee or eligible credit derivative; or
- (ii) Credit risk is covered on a pro rata basis (that is, on a basis in which the [BANK] and the protection provider share losses proportionately) by an eligible guarantee or eligible credit derivative.

(3) Exposures on which there is a tranching of credit risk (reflecting at least two different levels of seniority) generally are securitization exposures subject to §§ \_\_\_\_ .41 through \_\_\_\_ .45.

(4) If multiple eligible guarantees or eligible credit derivatives cover a single exposure described in this section, a [BANK] may treat the hedged exposure as multiple separate exposures each covered by a single eligible guarantee or eligible credit derivative and may calculate a separate risk-weighted asset amount for each separate exposure as described in paragraph (c) of this section.

(5) If a single eligible guarantee or eligible credit derivative covers multiple hedged exposures described in paragraph (a)(2) of this section, a [BANK] must treat each hedged exposure as covered by a separate eligible guarantee or eligible credit

derivative and must calculate a separate risk-weighted asset amount for each exposure as described in paragraph (c) of this section.

(b) *Rules of recognition.* (1) A [BANK] may only recognize the credit risk mitigation benefits of eligible guarantees and eligible credit derivatives.

(2) A [BANK] may only recognize the credit risk mitigation benefits of an eligible credit derivative to hedge an exposure that is different from the credit derivative's reference exposure used for determining the derivative's cash settlement value, deliverable obligation, or occurrence of a credit event if:

(i) The reference exposure ranks *pari passu* with, or is subordinated to, the hedged exposure; and

(ii) The reference exposure and the hedged exposure are to the same legal entity, and legally enforceable cross-default or cross-acceleration clauses are in place to ensure payments under the credit derivative are triggered when the obligated party of the hedged exposure fails to pay under the terms of the hedged exposure.

(c) *Substitution approach.* (1) *Full coverage.* If an eligible guarantee or eligible credit derivative meets the conditions in paragraphs (a) and (b) of this section and the protection amount (P) of the guarantee or credit derivative is greater than or equal to the exposure amount of the hedged exposure, a [BANK] may recognize the guarantee or credit derivative in determining the risk-weighted asset amount for the hedged exposure by substituting the risk weight applicable to the guarantor or credit derivative protection provider under § \_\_\_\_ .32 for the risk weight assigned to the exposure.

(2) *Partial coverage.* If an eligible guarantee or eligible credit derivative meets the conditions in §§ \_\_\_\_ .36(a) and \_\_\_\_ .37(b) and the protection amount (P) of the guarantee or credit derivative is less than the exposure amount of the hedged exposure, the [BANK] must treat the hedged exposure as two separate

exposures (protected and unprotected) in order to recognize the credit risk mitigation benefit of the guarantee or credit derivative.

(i) The [BANK] may calculate the risk-weighted asset amount for the protected exposure under § \_\_\_\_ .32, where the applicable risk weight is the risk weight applicable to the guarantor or credit derivative protection provider. (ii) The [BANK] must calculate the risk-weighted asset amount for the unprotected exposure under § \_\_\_\_ .32, where the applicable risk weight is that of the unprotected portion of the hedged exposure.

(ii) The treatment provided in this section is applicable when the credit risk of an exposure is covered on a partial pro rata basis and may be applicable when an adjustment is made to the effective notional amount of the guarantee or credit derivative under paragraphs (d), (e), or (f) of this section.

(d) *Maturity mismatch adjustment.* (1) A [BANK] that recognizes an eligible guarantee or eligible credit derivative in determining the risk-weighted asset amount for a hedged exposure must adjust the effective notional amount of the credit risk mitigant to reflect any maturity mismatch between the hedged exposure and the credit risk mitigant.

(2) A maturity mismatch occurs when the residual maturity of a credit risk mitigant is less than that of the hedged exposure(s).

(3) The residual maturity of a hedged exposure is the longest possible remaining time before the obligated party of the hedged exposure is scheduled to fulfil its obligation on the hedged exposure. If a credit risk mitigant has embedded options that may reduce its term, the [BANK] (protection purchaser) must use the shortest possible residual maturity for the credit risk mitigant. If a call is at the discretion of the protection provider, the residual maturity of the credit risk mitigant is at the first call date. If the call is at the discretion of the [BANK]

(protection purchaser), but the terms of the arrangement at origination of the credit risk mitigant contain a positive incentive for the [BANK] to call the transaction before contractual maturity, the remaining time to the first call date is the residual maturity of the credit risk mitigant.

(4) A credit risk mitigant with a maturity mismatch may be recognized only if its original maturity is greater than or equal to one year and its residual maturity is greater than three months.

(5) When a maturity mismatch exists, the [BANK] must apply the following adjustment to reduce the effective notional amount of the credit risk mitigant:  $P_m = E \times (t - 0.25) / (T - 0.25)$ , where:

(i)  $P_m$  = effective notional amount of the credit risk mitigant, adjusted for maturity mismatch;

(ii)  $E$  = effective notional amount of the credit risk mitigant;

(iii)  $t$  = the lesser of  $T$  or the residual maturity of the credit risk mitigant, expressed in years; and

(iv)  $T$  = the lesser of five or the residual maturity of the hedged exposure, expressed in years.

(e) *Adjustment for credit derivatives without restructuring as a credit event.* If a [BANK] recognizes an eligible credit derivative that does not include as a credit event a restructuring of the hedged exposure involving forgiveness or postponement of principal, interest, or fees that results in a credit loss event (that is, a charge-off, specific provision, or other similar debit to the profit and loss account), the [BANK] must apply the following adjustment to reduce the effective notional amount of the credit derivative:  $P_r = P_m \times 0.60$ , where:

(1)  $P_r$  = effective notional amount of the credit risk mitigant, adjusted for lack of restructuring event (and maturity mismatch, if applicable); and

(2)  $P_m$  = effective notional amount of the credit risk mitigant (adjusted for maturity mismatch, if applicable).

(f) *Currency mismatch adjustment.* (1) If a [BANK] recognizes an eligible guarantee or eligible credit derivative that is denominated in a currency different from that in which the hedged exposure is denominated, the [BANK] must apply the following formula to the effective notional amount of the guarantee or credit derivative:  $P_c = P_r \times (1 - H_{FX})$ , where:

(i)  $P_c$  = effective notional amount of the credit risk mitigant, adjusted for currency mismatch (and maturity mismatch and lack of restructuring event, if applicable);

(ii)  $P_r$  = effective notional amount of the credit risk mitigant (adjusted for maturity mismatch and lack of restructuring event, if applicable); and

(iii)  $H_{FX}$  = haircut appropriate for the currency mismatch between the credit risk mitigant and the hedged exposure.

(2) A [BANK] must set  $H_{FX}$  equal to eight percent unless it qualifies for the use of and uses its own internal estimates of foreign exchange volatility based on a ten-business-day holding period. A [BANK] qualifies for the use of its own internal estimates of foreign exchange volatility if it qualifies for the use of its own estimates haircuts in § \_\_\_\_\_.37(c)(4).

(3) A [BANK] must adjust  $H_{FX}$  calculated in paragraph (f)(2) of this section upward if the [BANK] revalues the guarantee or credit derivative less frequently than once every 10 business days using the following square root of time formula:

$$H_M = 8\% \sqrt{\frac{T_M}{10}}, \text{ where } T_M \text{ equals the greater of 10 or the number of days between}$$

reevaluation.

#### § \_\_\_\_\_.37 Collateralized transactions.

(a) *General.* (1) To recognize the risk-mitigating effects of financial collateral, a [BANK] may use:

(i) The simple approach in paragraph (b) of this section for any exposure.

(ii) The collateral haircut approach in paragraph (c) of this section for repo-style transactions, eligible margin loans, collateralized derivative contracts, and single-product netting sets of such transactions.

(2) A [BANK] may use any approach described in this section that is valid for a particular type of exposure or transaction; however, it must use the same approach for similar exposures or transactions.

(b) *The simple approach.* (1) *General requirements.* (i) A [BANK] may recognize the credit risk mitigation benefits of financial collateral that secures any exposure.

(ii) To qualify for the simple approach, the collateral must meet the following requirements:

(A) The collateral must be subject to a collateral agreement for at least the life of the exposure;

(B) The collateral must be revalued at least every six months; and

(C) The collateral (other than gold) and the exposure must be denominated in the same currency.

(2) *Risk weight substitution.* (i) A [BANK] may apply a risk weight to the portion of an exposure that is secured by the market value of collateral (that meets the requirements of paragraph (b)(1) of this section) based on the risk weight assigned to the collateral under § \_\_\_\_\_.32. For repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions, the collateral is the instruments, gold, and cash the [BANK] has borrowed, purchased subject to resale, or taken as collateral from the counterparty under the transaction. Except as provided in paragraph (b)(3) of this section, the risk weight assigned to the collateralized portion of the exposure may not be less than 20 percent.

(ii) A [BANK] must apply a risk weight to the unsecured portion of the exposure based on the risk weight assigned to the exposure under this subpart.

(3) *Exceptions to the 20 percent risk-weight floor and other requirements.* Notwithstanding paragraph (b)(2)(i) of this section:

(i) A [BANK] may assign a zero percent risk weight to an exposure to an OTC derivative contract that is marked-to-market on a daily basis and subject to a daily margin maintenance requirement, to the extent the contract is collateralized by cash on deposit.

(ii) A [BANK] may assign a 10 percent risk weight to an exposure to an OTC derivative contract that is marked-to-market daily and subject to a daily margin maintenance requirement, to the extent that the contract is collateralized by an exposure to a sovereign that qualifies for a zero percent risk weight under § \_\_\_\_\_.32.

(iii) A [BANK] may assign a zero percent risk weight to the collateralized portion of an exposure where:



(A) The financial collateral is cash on deposit; or

(B) The financial collateral is an exposure to a sovereign that qualifies for a zero percent risk weight under § \_\_\_\_.32, and the [BANK] has discounted the market value of the collateral by 20 percent.

(c) *Collateral haircut approach.* (1) *General.* A [BANK] may recognize the credit risk mitigation benefits of financial collateral that secures an eligible margin loan, repo-style transaction, collateralized derivative contract, or single-product netting set of such transactions, and of any collateral that secures a repo-style transaction that is included in the [BANK]'s VaR-based measure under subpart F by using the collateral haircut approach in this section. A [BANK] may use the standard supervisory haircuts in paragraph (c)(3) of this section or, with prior written approval of the [AGENCY], its own estimates of haircuts according to paragraph (c)(4) of this section.

(2) *Exposure amount equation.* A [BANK] must determine the exposure amount for an eligible margin loan, repo-style transaction, collateralized derivative contract, or a single-product netting set of such transactions by setting the exposure amount equal to

$\max \{0, [(\Sigma E - \Sigma C) + \Sigma (E_s \times H_s) + \Sigma (E_{fx} \times H_{fx})]\}$ , where:

(i)(A) For eligible margin loans and repo-style transactions and netting sets thereof,  $\Sigma E$  equals the value of the exposure (the sum of the current market values of all instruments, gold, and cash the [BANK] has lent, sold subject to repurchase, or posted as collateral to the counterparty under the transaction (or netting set)); and

(B) For collateralized derivative contracts and netting sets thereof,  $\Sigma E$  equals the exposure amount of the OTC derivative contract (or netting set) calculated under §§ \_\_\_\_.34 (c) or (d).

(ii)  $\Sigma C$  equals the value of the collateral (the sum of the current market values of all instruments, gold and cash the [BANK] has borrowed, purchased subject to resale, or taken as collateral from the counterparty under the transaction (or netting set));

(iii)  $E_s$  equals the absolute value of the net position in a given instrument or in gold (where the net position in the instrument or gold equals the sum of the current market values of the instrument or gold the [BANK] has lent, sold subject to repurchase, or posted as collateral to the counterparty minus the sum of the current market values of that same instrument or gold the [BANK] has

borrowed, purchased subject to resale, or taken as collateral from the counterparty);

(iv)  $H_s$  equals the market price volatility haircut appropriate to the instrument or gold referenced in  $E_s$ ;

(v)  $E_{fx}$  equals the absolute value of the net position of instruments and cash in a currency that is different from the settlement currency (where the net position in a given currency equals the sum of the current market values of any instruments or cash in the currency the [BANK] has lent, sold subject to repurchase, or posted as collateral to the counterparty minus the sum of the current market values of any instruments or cash in the currency the [BANK] has borrowed, purchased subject to resale, or taken as collateral from the counterparty); and

(vi)  $H_{fx}$  equals the haircut appropriate to the mismatch between the currency referenced in  $E_{fx}$  and the settlement currency.

(3) *Standard supervisory haircuts.* (i) A [BANK] must use the haircuts for market price volatility ( $H_s$ ) provided in Table 8, as adjusted in certain circumstances in accordance with the requirements of paragraphs (c)(3)(iii) and (iv) of this section:

TABLE 8—STANDARD SUPERVISORY MARKET PRICE VOLATILITY HAIRCUTS <sup>1</sup>

Residual maturity	Haircut (in percents) assigned based on:						Investment grade securitization exposures (in percent)
	Sovereign issuers risk weight under § ____.32 <sup>2</sup>			Non-sovereign issuers risk weight under § ____.32			
	Zero %	20% or 50%	100%	20%	50%	100%	
Less than or equal to 1 year .....	0.5	1.0	15.0	1.0	2.0	25.0	4.0
Greater than 1 year and less than or equal to 5 years .....	2.0	3.0	15.0	4.0	6.0	25.0	12.0
Greater than 5 years .....	4.0	6.0	15.0	8.0	12.0	25.0	24.0
Main index equities (including convertible bonds) and gold .....	15.0						
Other publicly-traded equities (including convertible bonds) .....	25.0						
Mutual funds .....	Highest haircut applicable to any security in which the fund can invest.						
Cash collateral held .....	Zero.						

<sup>1</sup> The market price volatility haircuts in Table 2 are based on a 10 business-day holding period.

<sup>2</sup> Includes a foreign PSE that receives a zero percent risk weight.

(ii) For currency mismatches, a [BANK] must use a haircut for foreign exchange rate volatility ( $H_{fx}$ ) of 8.0 percent, as adjusted in certain circumstances under paragraphs (c)(3)(iii) and (iv) of this section.

(iii) For repo-style transactions, a [BANK] may multiply the standard supervisory haircuts provided in paragraphs (c)(3)(i) and (ii) of this

section by the square root of  $\frac{1}{2}$  (which equals 0.707107).

(iv) If the number of trades in a netting set exceeds 5,000 at any time during a quarter, a [BANK] must adjust the supervisory haircuts provided in paragraphs (c)(3)(i) and (ii) of this section upward on the basis of a holding period of twenty business days for the following quarter except in the

calculation of the exposure amount for purposes of § \_\_\_\_.35. If a netting set contains one or more trades involving illiquid collateral or an OTC derivative that cannot be easily replaced, a [BANK] must adjust the supervisory haircuts upward on the basis of a holding period of twenty business days. If over the two previous quarters more than two margin disputes on a netting set have occurred

that lasted more than the holding period, then the [BANK] must adjust the supervisory haircuts upward for that netting set on the basis of a holding period that is at least two times the minimum holding period for that netting set. A [BANK] must adjust the standard supervisory haircuts upward using the following formula:

$$H_A = H_S \sqrt{\frac{T_M}{T_S}}, \text{ where,}$$

- (A)  $T_M$  equals a holding period of longer than 10 business days for eligible margin loans and derivative contracts or longer than 5 business days for repo-style transactions;
- (B)  $H_S$  equals the standard supervisory haircut; and
- (C)  $T_S$  equals 10 business days for eligible margin loans and derivative contracts or 5 business days for repo-style transactions.

(v) If the instrument a [BANK] has lent, sold subject to repurchase, or posted as collateral does not meet the definition of financial collateral, the [BANK] must use a 25.0 percent haircut for market price volatility ( $H_S$ ).

(4) *Own internal estimates for haircuts.* With the prior written approval of the [AGENCY], a [BANK] may calculate haircuts ( $H_S$  and  $H_{fx}$ ) using its own internal estimates of the volatilities of market prices and foreign exchange rates.

(i) To receive [AGENCY] approval to use its own internal estimates, a [BANK] must satisfy the following minimum standards:

(A) A [BANK] must use a 99th percentile one-tailed confidence interval.

(B) The minimum holding period for a repo-style transaction is five business days and for an eligible margin loan is ten business days except for transactions or netting sets for which paragraph (c)(4)(i)(C) of this section applies. When a [BANK] calculates an own-estimates haircut on a  $T_N$ -day holding period, which is different from the minimum holding period for the transaction type, the applicable haircut ( $H_M$ ) is calculated using the following square root of time formula:

$$H_M = H_N \sqrt{\frac{T_M}{T_N}}, \text{ where}$$

- (1)  $T_M$  equals 5 for repo-style transactions and 10 for eligible margin loans;
- (2)  $T_N$  equals the holding period used by the [BANK] to derive  $H_N$ ; and
- (3)  $H_N$  equals the haircut based on the holding period  $T_N$ .

(C) If the number of trades in a netting set exceeds 5,000 at any time during a

quarter, a [BANK] must calculate the haircut using a minimum holding period of twenty business days for the following quarter except in the calculation of the exposure amount for purposes of § \_\_.35. If a netting set contains one or more trades involving illiquid collateral or an OTC derivative that cannot be easily replaced, a [BANK] must calculate the haircut using a minimum holding period of twenty business days. If over the two previous quarters more than two margin disputes on a netting set have occurred that lasted more than the holding period, then the [BANK] must calculate the haircut for transactions in that netting set on the basis of a holding period that is at least two times the minimum holding period for that netting set.

(D) A [BANK] is required to calculate its own internal estimates with inputs calibrated to historical data from a continuous 12-month period that reflects a period of significant financial stress appropriate to the security or category of securities.

(E) A [BANK] must have policies and procedures that describe how it determines the period of significant financial stress used to calculate the [BANK]'s own internal estimates for haircuts under this section and must be able to provide empirical support for the period used. The [BANK] must obtain the prior approval of the [AGENCY] for, and notify the [AGENCY] if the [BANK] makes any material changes to, these policies and procedures.

(F) Nothing in this section prevents the [AGENCY] from requiring a [BANK] to use a different period of significant financial stress in the calculation of own internal estimates for haircuts.

(G) A [BANK] must update its data sets and calculate haircuts no less frequently than quarterly and must also reassess data sets and haircuts whenever market prices change materially.

(ii) With respect to debt securities that are investment grade, a [BANK] may calculate haircuts for categories of securities. For a category of securities, the [BANK] must calculate the haircut on the basis of internal volatility estimates for securities in that category that are representative of the securities in that category that the [BANK] has lent, sold subject to repurchase, posted as collateral, borrowed, purchased subject to resale, or taken as collateral. In determining relevant categories, the [BANK] must at a minimum take into account:

- (A) The type of issuer of the security;
- (B) The credit quality of the security;
- (C) The maturity of the security; and
- (D) The interest rate sensitivity of the security.

(iii) With respect to debt securities that are not investment grade and equity securities, a [BANK] must calculate a separate haircut for each individual security.

(iv) Where an exposure or collateral (whether in the form of cash or securities) is denominated in a currency that differs from the settlement currency, the [BANK] must calculate a separate currency mismatch haircut for its net position in each mismatched currency based on estimated volatilities of foreign exchange rates between the mismatched currency and the settlement currency.

(v) A [BANK]'s own estimates of market price and foreign exchange rate volatilities may not take into account the correlations among securities and foreign exchange rates on either the exposure or collateral side of a transaction (or netting set) or the correlations among securities and foreign exchange rates between the exposure and collateral sides of the transaction (or netting set).

#### *RISK-WEIGHTED ASSETS FOR UNSETTLED TRANSACTIONS*

#### **§ \_\_.38 Unsettled transactions.**

(a) *Definitions.* For purposes of this section:

(1) *Delivery-versus-payment (DvP) transaction* means a securities or commodities transaction in which the buyer is obligated to make payment only if the seller has made delivery of the securities or commodities and the seller is obligated to deliver the securities or commodities only if the buyer has made payment.

(2) *Payment-versus-payment (PvP) transaction* means a foreign exchange transaction in which each counterparty is obligated to make a final transfer of one or more currencies only if the other counterparty has made a final transfer of one or more currencies.

(3) *Normal settlement period:* a transaction has a normal settlement period if the contractual settlement period for the transaction is equal to or less than the market standard for the instrument underlying the transaction and equal to or less than five business days.

(4) *Positive current exposure* of a [BANK] for a transaction is the difference between the transaction value at the agreed settlement price and the current market price of the transaction, if the difference results in a credit exposure of the [BANK] to the counterparty.

(b) *Scope.* This section applies to all transactions involving securities, foreign exchange instruments, and commodities

that have a risk of delayed settlement or delivery. This section does not apply to:

- (1) Cleared transactions that are marked-to-market daily and subject to daily receipt and payment of variation margin;
- (2) Repo-style transactions, including unsettled repo-style transactions;
- (3) One-way cash payments on OTC derivative contracts; or
- (4) Transactions with a contractual settlement period that is longer than the normal settlement period (which are treated as OTC derivative contracts as provided in § .34).

(c) *System-wide failures.* In the case of a system-wide failure of a settlement, clearing system or central counterparty, the [AGENCY] may waive risk-based capital requirements for unsettled and failed transactions until the situation is rectified.

(d) *Delivery-versus-payment (DvP) and payment-versus-payment (PvP) transactions.* A [BANK] must hold risk-based capital against any DvP or PvP transaction with a normal settlement period if the [BANK]'s counterparty has not made delivery or payment within five business days after the settlement date. The [BANK] must determine its risk-weighted asset amount for such a transaction by multiplying the positive current exposure of the transaction for the [BANK] by the appropriate risk weight in Table 9.

TABLE 9—RISK WEIGHTS FOR UNSETTLED DVP AND PVP TRANSACTIONS

Number of business days after contractual settlement date	Risk weight to be applied to positive current exposure (in percent)
From 5 to 15 .....	100.0
From 16 to 30 .....	625.0
From 31 to 45 .....	937.5
46 or more .....	1,250.0

(e) *Non-DvP/non-PvP (non-delivery-versus-payment/non-payment-versus-payment) transactions.* (1) A [BANK] must hold risk-based capital against any non-DvP/non-PvP transaction with a normal settlement period if the [BANK] has delivered cash, securities, commodities, or currencies to its counterparty but has not received its corresponding deliverables by the end of the same business day. The [BANK] must continue to hold risk-based capital against the transaction until the [BANK] has received its corresponding deliverables.

(2) From the business day after the [BANK] has made its delivery until five business days after the counterparty delivery is due, the [BANK] must

calculate the risk-weighted asset amount for the transaction by treating the current market value of the deliverables owed to the [BANK] as an exposure to the counterparty and using the applicable counterparty risk weight under § .32.

(3) If the [BANK] has not received its deliverables by the fifth business day after counterparty delivery was due, the [BANK] must assign a 1,250 percent risk weight to the current market value of the deliverables owed to the [BANK].

(f) *Total risk-weighted assets for unsettled transactions.* Total risk-weighted assets for unsettled transactions is the sum of the risk-weighted asset amounts of all DvP, PvP, and non-DvP/non-PvP transactions.

**RISK-WEIGHTED ASSETS FOR SECURITIZATION EXPOSURES**

**§ .41 Operational requirements for securitization exposures.**

(a) *Operational criteria for traditional securitizations.* A [BANK] that transfers exposures it has originated or purchased to a securitization SPE or other third party in connection with a traditional securitization may exclude the exposures from the calculation of its risk-weighted assets only if each condition in this section is satisfied. A [BANK] that meets these conditions must hold risk-based capital against any credit risk it retains in connection with the securitization. A [BANK] that fails to meet these conditions must hold risk-based capital against the transferred exposures as if they had not been securitized and must deduct from common equity tier 1 capital any after-tax gain-on-sale resulting from the transaction. The conditions are:

(1) The exposures are not reported on the [BANK]'s consolidated balance sheet under GAAP;

(2) The [BANK] has transferred to one or more third parties credit risk associated with the underlying exposures; and

(3) Any clean-up calls relating to the securitization are eligible clean-up calls.

(4) The securitization does not:

(i) Include one or more underlying exposures in which the borrower is permitted to vary the drawn amount within an agreed limit under a line of credit; and

(ii) Contain an early amortization provision.

(b) *Operational criteria for synthetic securitizations.* For synthetic securitizations, a [BANK] may recognize for risk-based capital purposes the use of a credit risk mitigant to hedge underlying exposures only if each condition in this paragraph is satisfied.

A [BANK] that meets these conditions must hold risk-based capital against any credit risk of the exposures it retains in connection with the synthetic securitization. A [BANK] that fails to meet these conditions or chooses not to recognize the credit risk mitigant for purposes of this section must instead hold risk-based capital against the underlying exposures as if they had not been synthetically securitized. The conditions are:

(1) The credit risk mitigant is financial collateral, an eligible credit derivative, or an eligible guarantee;

(2) The [BANK] transfers credit risk associated with the underlying exposures to one or more third parties, and the terms and conditions in the credit risk mitigants employed do not include provisions that:

(i) Allow for the termination of the credit protection due to deterioration in the credit quality of the underlying exposures;

(ii) Require the [BANK] to alter or replace the underlying exposures to improve the credit quality of the pool of underlying exposures;

(iii) Increase the [BANK]'s cost of credit protection in response to deterioration in the credit quality of the underlying exposures;

(iv) Increase the yield payable to parties other than the [BANK] in response to a deterioration in the credit quality of the underlying exposures; or

(v) Provide for increases in a retained first loss position or credit enhancement provided by the [BANK] after the inception of the securitization;

(3) The [BANK] obtains a well-reasoned opinion from legal counsel that confirms the enforceability of the credit risk mitigant in all relevant jurisdictions; and

(4) Any clean-up calls relating to the securitization are eligible clean-up calls.

(c) *Due diligence requirements.* (1) Except for exposures that are deducted from common equity tier 1 capital, if a [BANK] is unable to demonstrate to the satisfaction of the [AGENCY] a comprehensive understanding of the features of a securitization exposure that would materially affect the performance of the exposure, the [BANK] must assign the securitization exposure a risk weight of 1,250 percent. The [BANK]'s analysis must be commensurate with the complexity of the securitization exposure and the materiality of the exposure in relation to its capital.

(2) A [BANK] must demonstrate its comprehensive understanding of a securitization exposure under paragraph (c)(1) of this section, for each securitization exposure by:

(i) Conduct an analysis of the risk characteristics of a securitization exposure prior to acquiring the exposure, and document such analysis within three business days after acquiring the exposure, considering:

(A) Structural features of the securitization that would materially impact the performance of the exposure, for example, the contractual cash flow waterfall, waterfall-related triggers, credit enhancements, liquidity enhancements, market value triggers, the performance of organizations that service the exposure, and deal-specific definitions of default;

(B) Relevant information regarding the performance of the underlying credit exposure(s), for example, the percentage of loans 30, 60, and 90 days past due; default rates; prepayment rates; loans in foreclosure; property types; occupancy; average credit score or other measures of creditworthiness; average LTV ratio; and industry and geographic diversification data on the underlying exposure(s);

(C) Relevant market data of the securitization, for example, bid-ask spread, most recent sales price and historic price volatility, trading volume, implied market rating, and size, depth and concentration level of the market for the securitization; and

(D) In addition, for resecuritization exposures, performance information on the underlying securitization exposures, for example, the issuer name and credit quality, and the characteristics and performance of the exposures underlying the securitization exposures.

(ii) On an on-going basis (no less frequently than quarterly), evaluating, reviewing, and updating as appropriate the analysis required under paragraph (c)(1) of this section for each securitization exposure.

**§ \_\_\_\_ .42 Risk-weighted assets for securitization exposures.**

(a) *Securitization risk weight approaches.* Except as provided elsewhere in this section or in § \_\_\_\_ .41:

(1) A [BANK] must deduct from common equity tier 1 capital any after-tax gain-on-sale resulting from a securitization and apply a 1,250 percent risk weight to the portion of a CEIO that does not constitute after-tax gain-on-sale.

(2) If a securitization exposure does not require deduction under paragraph (a)(1) of this section, a [BANK] may assign a risk weight to the securitization exposure using the simplified supervisory formula approach (SSFA) in accordance with §§ \_\_\_\_ .43(a) through \_\_\_\_ .43(d). Alternatively, a [BANK] that is not subject to subpart F may assign a risk weight to the securitization

exposure using the gross-up approach in accordance with § \_\_\_\_ .43(e). The [BANK] must apply either the SSFA or the gross-up approach consistently across all of its securitization exposures.

(3) If a securitization exposure does not require deduction under paragraph (a)(1) of this section and the [BANK] cannot, or chooses not to apply the SSFA or the gross-up approach to the exposure, the [BANK] must assign a risk weight to the exposure as described in § \_\_\_\_ .44.

(4) If a securitization exposure is a derivative contract (other than a credit derivative) that has a first priority claim on the cash flows from the underlying exposures (notwithstanding amounts due under interest rate or currency derivative contracts, fees due, or other similar payments), with approval of the [AGENCY], a [BANK] may choose to set the risk-weighted asset amount of the exposure equal to the amount of the exposure as determined in paragraph (c) of this section.

(b) *Total risk-weighted assets for securitization exposures.* A [BANK]'s total risk-weighted assets for securitization exposures equals the sum of the risk-weighted asset amount for securitization exposures that the [BANK] risk weights under §§ \_\_\_\_ .41(c), \_\_\_\_ .42(a)(1), and \_\_\_\_ .43, \_\_\_\_ .44, or \_\_\_\_ .45, except as provided in §§ \_\_\_\_ .42(e) through (j).

(c) *Exposure amount of a securitization exposure.* (1) *On-balance sheet securitization exposures.* The exposure amount of an on-balance sheet securitization exposure that is not a repo-style transaction, eligible margin loan, or OTC derivative contract (other than a credit derivative) is equal to the carrying value of the exposure.

(2) *Off-balance sheet securitization exposures.* (i) The exposure amount of an off-balance sheet securitization exposure that is not a repo-style transaction, eligible margin loan, or an OTC derivative contract (other than a credit derivative) is the notional amount of the exposure, except for an eligible asset-backed commercial paper (ABCP) liquidity facility. For an off-balance sheet securitization exposure to an ABCP program, such as an eligible ABCP liquidity facility, the notional amount may be reduced to the maximum potential amount that the [BANK] could be required to fund given the ABCP program's current underlying assets (calculated without regard to the current credit quality of those assets).

(ii) A [BANK] must determine the exposure amount of an eligible ABCP liquidity facility for which the SSFA does not apply by multiplying the

notional amount of the exposure by a CCF of 50 percent.

(iii) A [BANK] must determine the exposure amount of an eligible ABCP liquidity facility for which the SSFA applies by multiplying the notional amount of the exposure by a CCF of 100 percent.

(3) *Repo-style transactions, eligible margin loans, and derivative contracts.* The exposure amount of a securitization exposure that is a repo-style transaction, eligible margin loan, or derivative contract (other than a credit derivative) is the exposure amount of the transaction as calculated under § \_\_\_\_ .34 or § \_\_\_\_ .37 as applicable.

(d) *Overlapping exposures.* If a [BANK] has multiple securitization exposures that provide duplicative coverage to the underlying exposures of a securitization (such as when a [BANK] provides a program-wide credit enhancement and multiple pool-specific liquidity facilities to an ABCP program), the [BANK] is not required to hold duplicative risk-based capital against the overlapping position. Instead, the [BANK] may apply to the overlapping position the applicable risk-based capital treatment that results in the highest risk-based capital requirement.

(e) *Implicit support.* If a [BANK] provides support to a securitization in excess of the [BANK]'s contractual obligation to provide credit support to the securitization (implicit support):

(1) The [BANK] must include in risk-weighted assets all of the underlying exposures associated with the securitization as if the exposures had not been securitized and must deduct from common equity tier 1 capital any after-tax gain-on-sale resulting from the securitization; and

(2) The [BANK] must disclose publicly:

(i) That it has provided implicit support to the securitization; and

(ii) The risk-based capital impact to the [BANK] of providing such implicit support.

(f) *Undrawn portion of an eligible servicer cash advance facility.* Regardless of any other provision of this subpart, a [BANK] is not required to hold risk-based capital against the undrawn portion of an eligible servicer cash advance facility.

(g) *Interest-only mortgage-backed securities.* Regardless of any other provisions of this subpart, the risk weight for a non-credit-enhancing interest-only mortgage-backed security may not be less than 100 percent.

(h) *Small-business loans and leases on personal property transferred with retained contractual exposure.* (1) Regardless of any other provisions of

this subpart, a [BANK] that has transferred small-business loans and leases on personal property (small-business obligations) must include in risk-weighted assets only its contractual exposure to the small-business obligations if all the following conditions are met:

(i) The transaction must be treated as a sale under GAAP.

(ii) The [BANK] establishes and maintains, pursuant to GAAP, a non-capital reserve sufficient to meet the [BANK]'s reasonably estimated liability under the contractual obligation.

(iii) The small business obligations are to businesses that meet the criteria for a small-business concern established by the Small Business Administration under section 3(a) of the Small Business Act.

(iv) The [BANK] is well capitalized, as defined in the [AGENCY]'s prompt corrective action regulation. For purposes of determining whether a [BANK] is well capitalized for purposes of this paragraph, the [BANK]'s capital ratios must be calculated without regard to the capital treatment for transfers of small-business obligations under this paragraph.

(2) The total outstanding amount of contractual exposure retained by a [BANK] on transfers of small-business obligations receiving the capital treatment specified in paragraph (h)(1) of this section cannot exceed 15 percent of the [BANK]'s total capital.

(3) If a [BANK] ceases to be well capitalized or exceeds the 15 percent capital limitation provided in paragraph (h)(2) of this section, the capital treatment under paragraph (h)(1) of this section will continue to apply to any transfers of small-business obligations with retained contractual exposure that occurred during the time that the [BANK] was well capitalized and did not exceed the capital limit.

(4) The risk-based capital ratios of the [BANK] must be calculated without regard to the capital treatment for transfers of small-business obligations specified in paragraph (h)(1) of this section for purposes of:

(i) Determining whether a [BANK] is adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized under the [AGENCY]'s prompt corrective action regulations; and

(ii) Reclassifying a well-capitalized [BANK] to adequately capitalized and requiring an adequately capitalized [BANK] to comply with certain mandatory or discretionary supervisory actions as if the [BANK] were in the

next lower prompt-corrective-action category.

(i) *Nth-to-default credit derivatives.* (1) *Protection provider.* A [BANK] may assign a risk weight using the SSFA in § \_\_.43 to an nth-to-default credit derivative in accordance with this paragraph. A [BANK] must determine its exposure in the nth-to-default credit derivative as the largest notional dollar amount of all the underlying exposures.

(2) For purposes of determining the risk weight for an nth-to-default credit derivative using the SSFA, the [BANK] must calculate the attachment point and detachment point of its exposure as follows:

(i) The attachment point (parameter A) is the ratio of the sum of the notional amounts of all underlying exposures that are subordinated to the [BANK]'s exposure to the total notional amount of all underlying exposures. In the case of a first-to-default credit derivative, there are no underlying exposures that are subordinated to the [BANK]'s exposure. In the case of a second-or-subsequent-to-default credit derivative, the smallest (n-1) notional amounts of the underlying exposure(s) are subordinated to the [BANK]'s exposure.

(ii) The detachment point (parameter D) equals the sum of parameter A plus the ratio of the notional amount of the [BANK]'s exposure in the nth-to-default credit derivative to the total notional amount of all underlying exposures.

(3) A [BANK] that does not use the SSFA to determine a risk weight for its nth-to-default credit derivative must assign a risk weight of 1,250 percent to the exposure.

(4) *Protection purchaser.* (i) *First-to-default credit derivatives.* A [BANK] that obtains credit protection on a group of underlying exposures through a first-to-default credit derivative that meets the rules of recognition of § \_\_.36(b) must determine its risk-based capital requirement for the underlying exposures as if the [BANK] synthetically securitized the underlying exposure with the smallest risk-weighted asset amount and had obtained no credit risk mitigant on the other underlying exposures. A [BANK] must calculate a risk-based capital requirement for counterparty credit risk according to § \_\_.34 for a first-to-default credit derivative that does not meet the rules of recognition of § \_\_.36(b).

(ii) *Second-or-subsequent-to-default credit derivatives.* (A) A [BANK] that obtains credit protection on a group of underlying exposures through a nth -to-default credit derivative that meets the rules of recognition of § \_\_.36(b) (other than a first-to-default credit derivative)

may recognize the credit risk mitigation benefits of the derivative only if:

(1) The [BANK] also has obtained credit protection on the same underlying exposures in the form of first-through-(n-1)-to-default credit derivatives; or

(2) If n-1 of the underlying exposures have already defaulted.

(B) If a [BANK] satisfies the requirements of paragraph (i)(4)(ii)(A) of this section, the [BANK] must determine its risk-based capital requirement for the underlying exposures as if the [BANK] had only synthetically securitized the underlying exposure with the smallest risk-weighted asset amount.

(C) A [BANK] must calculate a risk-based capital requirement for counterparty credit risk according to § \_\_.34 for a nth-to-default credit derivative that does not meet the rules of recognition of § \_\_.36(b).

(j) *Guarantees and credit derivatives other than N-th to default credit derivatives.* (1) *Protection provider.* For a guarantee or credit derivative (other than an nth-to-default credit derivative) provided by a [BANK] that covers the full amount or a pro rata share of a securitization exposure's principal and interest, the [BANK] must risk weight the guarantee or credit derivative as if it holds the portion of the reference exposure covered by the guarantee or credit derivative.

(2) *Protection purchaser.* (i) If a [BANK] chooses (and is able) to recognize a guarantee or credit derivative (other than an nth-to-default credit derivative) that references a securitization exposure as a credit risk mitigant, where applicable, the [BANK] must apply § \_\_.45.

(ii) If a [BANK] cannot, or chooses not to, recognize a credit derivative that references a securitization exposure as a credit risk mitigant under § \_\_.45, the [BANK] must determine its capital requirement only for counterparty credit risk in accordance with § \_\_.31.

**§ \_\_.43. Simplified supervisory formula approach (SSFA) and the gross-up approach.**

(a) *General requirements.* To use the SSFA to determine the risk weight for a securitization exposure, a [BANK] must have data that enables it to assign accurately the parameters described in paragraph (b) of this section. Data used to assign the parameters described in paragraph (b) of this section must be the most currently available data and no more than 91 calendar days old. A [BANK] that does not have the appropriate data to assign the parameters described in paragraph (b) of

this section must assign a risk weight of 1,250 percent to the exposure.

(b) *SSFA parameters.* To calculate the risk weight for a securitization exposure using the SSFA, a [BANK] must have accurate information on the following five inputs to the SSFA calculation:

(1)  $K_G$  is the weighted-average (with unpaid principal used as the weight for each exposure) total capital requirement of the underlying exposures calculated using this subpart.  $K_G$  is expressed as a decimal value between zero and 1 (that is, an average risk weight of 100 percent represents a value of  $K_G$  equal to .08).

(2) Parameter W is expressed as a decimal value between zero and one. Parameter W is the ratio of the sum of the dollar amounts of any underlying exposures within the securitized pool that meet any of the criteria as set forth in paragraphs (b)(2)(i) through (vi) of this section to the ending balance, measured in dollars, of underlying exposures:

- (i) Ninety days or more past due,
- (ii) Subject to a bankruptcy or insolvency proceeding,
- (iii) In the process of foreclosure,
- (iv) Held as real estate owned;
- (v) Has contractually deferred interest payments for 90 days or more; or
- (vi) Is in default.

(3) Parameter A is the attachment point for the exposure, which represents the threshold at which credit losses will

first be allocated to the exposure. Parameter A equals the ratio of the current dollar amount of underlying exposures that are subordinated to the exposure of the [BANK] to the current dollar amount of underlying exposures. Any reserve account funded by the accumulated cash flows from the underlying exposures that is subordinated to the [BANK]'s securitization exposure may be included in the calculation of parameter A to the extent that cash is present in the account. Parameter A is expressed as a decimal value between zero and one.

(4) Parameter D is the detachment point for the exposure, which represents the threshold at which credit losses of principal allocated to the exposure would result in a total loss of principal. Parameter D equals parameter A plus the ratio of the current dollar amount of the securitization exposures that are *pari passu* with the exposure (that is, have equal seniority with respect to credit risk) to the current dollar amount of the underlying exposures. Parameter D is expressed as a decimal value between zero and one.

(5) A supervisory calibration parameter,  $p$ , is equal to 0.5 for securitization exposures that are not resecuritization exposures and equal to 1.5 for resecuritization exposures.

(c) *Mechanics of the SSFA.*  $K_G$  and W are used to calculate  $K_A$ , the augmented

value of  $K_G$ , which reflects the observed credit quality of the underlying pool of exposures.  $K_A$  is defined in paragraph (d) of this section. The values of parameters A and D, relative to  $K_A$  determine the risk weight assigned to a securitization exposure as described in paragraph (d) of this section. The risk weight assigned to a securitization exposure, or portion of an exposure, as appropriate, is the larger of the risk weight determined in accordance with this paragraphs (c) and (d) of this section and a risk weight of 20 percent.

(1) When the detachment point, parameter D, for a securitization exposure is less than or equal to  $K_A$ , the exposure must be assigned a risk weight of 1,250 percent.

(2) When the attachment point, parameter A, for a securitization exposure is greater than or equal to  $K_A$ , the [BANK] must calculate the risk weight in accordance with paragraph (d) of this section.

(3) When A is less than  $K_A$  and D is greater than  $K_A$ , the risk weight is a weighted-average of 1,250 percent and 1,250 percent times  $K_{SSFA}$  calculated in accordance with paragraph (d) of this section, but with the parameter A revised to be set equal to  $K_A$ . For the purpose of this weighted-average calculation:

- (i) The weight assigned to 1,250 percent equals  $\frac{K_A - A}{D - A}$ .
- (ii) The weight assigned to 1,250 percent times  $K_{SSFA}$  equals  $\frac{D - K_A}{D - A}$ .
- (iii) The risk weight will be set equal to:

$$RW = \left[ \left( \frac{K_A - A}{D - A} \right) \times 1,250 \text{ percent} \right] + \left[ \left( \frac{D - K_A}{D - A} \right) \times 1,250 \text{ percent} \times K_{SSFA} \right]$$

- (d) SSFA equation. (1) The [BANK] must define the following parameters:

$$K_A = (1 - W) \cdot K_G + (.5 \cdot W)$$

$$a = -\frac{1}{p \cdot K_A}$$

$$u = D - K_A$$

$$l = A - K_A$$

$$e = 2.71828$$

, the base of the natural logarithms.

- (2) Then the [BANK] must calculate  $K_{SSFA}$  according to the following equation:

$$K_{SSFA} = \frac{e^{a \cdot u} - e^{a \cdot l}}{a(u - l)}$$

- (3) The risk weight for the exposure (expressed as a percent) is equal to  $K_{SSFA} \times 1,250$ .

(e) *Gross-up approach.* (1) *Applicability.* A [BANK] that is not subject to subpart F may apply the gross-up approach set forth in this section instead of the SSFA to determine the risk weight of its securitization exposures, provided that it applies the gross-up approach or a 1,250 percent risk weight to all of its securitization exposures, except as otherwise provided for certain securitization exposures in § .44 and .45.

(2) To use the gross-up approach, a [BANK] must calculate the following four inputs:

(i) Pro rata share, which is the par value of the [BANK]'s securitization exposure as a percent of the par value

of the tranche in which the securitization exposure resides;

(ii) Enhanced amount, which is the value of tranches that are more senior to the tranche in which the [BANK]'s securitization resides;

(iii) Exposure amount of the [BANK]'s securitization exposure calculated under § .42(c); and

(iv) Risk weight, which is the weighted-average risk weight of underlying exposures in the securitization pool as calculated under this subpart.

(3) *Credit equivalent amount.* The credit equivalent amount of a securitization exposure under this section equals the sum of the exposure amount of the [BANK]'s securitization

exposure and the pro rata share multiplied by the enhanced amount, each calculated in accordance with paragraph (e)(2) of this section.

(4) *Risk-weighted assets.* To calculate risk-weighted assets for a securitization exposure under the gross-up approach, a [BANK] must apply the risk weight calculated under paragraph (e)(2) of this section to the credit equivalent amount calculated in paragraph (e)(3) of this section.

(f) *Limitations.* Notwithstanding any other provision of this section, a [BANK] must assign a risk weight of not less than 20 percent to a securitization exposure.

**§ \_\_\_\_ .44. Securitization exposures to which the SSFA and gross-up approach do not apply.**

(a) *General Requirement.* A [BANK] must assign a 1,250 percent risk weight to all securitization exposures to which the [BANK] does not apply the SSFA or the gross up approach under § \_\_\_\_ .43, except as set forth in this section;

(b) *Eligible ABCP liquidity facilities.* A [BANK] may determine the risk-weighted asset amount of an eligible ABCP liquidity facility by multiplying the exposure amount by the highest risk weight applicable to any of the individual underlying exposures covered by the facility.

(c) *A securitization exposure in a second loss position or better to an ABCP program.* (1) *Risk weighting.* A [BANK] may determine the risk-weighted asset amount of a securitization exposure that is in a second loss position or better to an ABCP program that meets the requirements of paragraph (c)(2) of this section by multiplying the exposure amount by the higher of the following risk weights:

(i) 100 percent; and  
(ii) The highest risk weight applicable to any of the individual underlying exposures of the ABCP program.

(2) *Requirements.* (i) The exposure is not an eligible ABCP liquidity facility;  
(ii) The exposure must be economically in a second loss position or better, and the first loss position must provide significant credit protection to the second loss position;

(iii) The exposure qualifies as investment grade; and

(iv) The [BANK] holding the exposure must not retain or provide protection to the first loss position.

**§ \_\_\_\_ .45 Recognition of credit risk mitigants for securitization exposures.**

(a) *General.* (1) An originating [BANK] that has obtained a credit risk mitigant to hedge its exposure to a synthetic or traditional securitization that satisfies the operational criteria provided in § \_\_\_\_ .41 may recognize the credit risk mitigant under §§ \_\_\_\_ .36 or \_\_\_\_ .37, but only as provided in this section.

(2) An investing [BANK] that has obtained a credit risk mitigant to hedge a securitization exposure may recognize the credit risk mitigant under §§ \_\_\_\_ .36 or \_\_\_\_ .37, but only as provided in this section.

(b) *Eligible guarantors for securitization exposures.* A [BANK] may only recognize an eligible guarantee or eligible credit derivative from an eligible guarantor.

(c) *Mismatches.* A [BANK] must make any applicable adjustment to the

protection amount of an eligible guarantee or credit derivative as required in §§ \_\_\_\_ .36(d), (e), and (f) for any hedged securitization exposure. In the context of a synthetic securitization, when an eligible guarantee or eligible credit derivative covers multiple hedged exposures that have different residual maturities, the [BANK] must use the longest residual maturity of any of the hedged exposures as the residual maturity of all hedged exposures.

**Risk-weighted Assets For Equity Exposures**

**§ \_\_\_\_ .51 Introduction and exposure measurement.**

(a) *General.* To calculate its risk-weighted asset amounts for equity exposures that are not equity exposures to an investment fund, a [BANK] must use the Simple Risk-Weight Approach (SRWA) provided in § \_\_\_\_ .52. A [BANK] must use the look-through approaches provided in § \_\_\_\_ .53 to calculate its risk-weighted asset amounts for equity exposures to investment funds.

(b) *Adjusted carrying value.* For purposes of §§ \_\_\_\_ .51 through \_\_\_\_ .53, the adjusted carrying value of an equity exposure is:

(1) For the on-balance sheet component of an equity exposure, the [BANK]'s carrying value of the exposure and

(2) For the off-balance sheet component of an equity exposure that is not an equity commitment, the effective notional principal amount of the exposure, the size of which is equivalent to a hypothetical on-balance sheet position in the underlying equity instrument that would evidence the same change in fair value (measured in dollars) given a small change in the price of the underlying equity instrument, minus the adjusted carrying value of the on-balance sheet component of the exposure as calculated in paragraph (b)(1) of this section.

(3) For a commitment to acquire an equity exposure (an equity commitment), the effective notional principal amount of the exposure is multiplied by the following conversion factors (CFs):

(i) Conditional equity commitments with an original maturity of one year or less receive a CF of 20 percent.

(ii) Conditional equity commitments with an original maturity of over one year receive a CF of 50 percent.

(iii) Unconditional equity commitments receive a CF of 100 percent.

**§ \_\_\_\_ .52 Simple risk-weight approach (SRWA).**

(a) *General.* Under the SRWA, a [BANK]'s total risk-weighted assets for equity exposures equals the sum of the risk-weighted asset amounts for each of the [BANK]'s individual equity exposures (other than equity exposures to an investment fund) as determined under this section and the risk-weighted asset amounts for each of the [BANK]'s individual equity exposures to an investment fund as determined under § \_\_\_\_ .53.

(b) *SRWA computation for individual equity exposures.* A [BANK] must determine the risk-weighted asset amount for an individual equity exposure (other than an equity exposure to an investment fund) by multiplying the adjusted carrying value of the equity exposure or the effective portion and ineffective portion of a hedge pair (as defined in paragraph (c) of this section) by the lowest applicable risk weight in this paragraph.

(1) *Zero percent risk weight equity exposures.* An equity exposure to a sovereign, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, an MDB, and any other entity whose credit exposures receive a zero percent risk weight under § \_\_\_\_ .32 may be assigned a zero percent risk weight.

(2) *20 percent risk weight equity exposures.* An equity exposure to a PSE, Federal Home Loan Bank or the Federal Agricultural Mortgage Corporation (Farmer Mac) must be assigned a 20 percent risk weight.

(3) *100 percent risk weight equity exposures.* The following equity exposures must be assigned a 100 percent risk weight:

(i) *Community development equity exposures.*

(A) For [BANK]s, savings and loan holding companies, and bank holding companies, an equity exposure that qualifies as a community development investment under § \_\_\_\_ .24 (Eleventh) of the National Bank Act, excluding equity exposures to an unconsolidated small business investment company and equity exposures held through a consolidated small business investment company described in section 302 of the Small Business Investment Act.

(B) For savings associations, an equity exposure that is designed primarily to promote community welfare, including the welfare of low- and moderate-income communities or families, such as by providing services or employment, and excluding equity exposures to an unconsolidated small business investment company and equity



exposures held through a small business investment company described in section 302 of the Small Business Investment Act.

(ii) *Effective portion of hedge pairs.* The effective portion of a hedge pair.

(iii) *Non-significant equity exposures.* Equity exposures, excluding exposures to an investment firm that would meet the definition of a traditional securitization were it not for the application of paragraph (8) of that definition in § \_\_\_\_.2 and has greater than immaterial leverage, to the extent that the aggregate adjusted carrying value of the exposures does not exceed 10 percent of the [BANK]'s total capital.

(A) To compute the aggregate adjusted carrying value of a [BANK]'s equity exposures for purposes of this section, the [BANK] may exclude equity exposures described in paragraphs (b)(1), (b)(2), (b)(3)(i), and (b)(3)(ii) of this section, the equity exposure in a hedge pair with the smaller adjusted carrying value, and a proportion of each equity exposure to an investment fund equal to the proportion of the assets of the investment fund that are not equity exposures or that meet the criterion of paragraph (b)(3)(i) of this section. If a [BANK] does not know the actual holdings of the investment fund, the [BANK] may calculate the proportion of the assets of the fund that are not equity exposures based on the terms of the prospectus, partnership agreement, or similar contract that defines the fund's permissible investments. If the sum of the investment limits for all exposure classes within the fund exceeds 100 percent, the [BANK] must assume for purposes of this section that the investment fund invests to the

maximum extent possible in equity exposures.

(B) When determining which of a [BANK]'s equity exposures qualify for a 100 percent risk weight under this paragraph, a [BANK] first must include equity exposures to unconsolidated small business investment companies or held through consolidated small business investment companies described in section 302 of the Small Business Investment Act, then must include publicly-traded equity exposures (including those held indirectly through investment funds), and then must include nonpublicly-traded equity exposures (including those held indirectly through investment funds).

(4) *250 percent risk weight equity exposures.* Significant investments in the capital of unconsolidated financial institutions that are not deducted from capital pursuant to § \_\_\_\_.22(d) are assigned a 250 percent risk weight.

(5) *300 percent risk weight equity exposures.* A publicly-traded equity exposure (other than an equity exposure described in paragraph (b)(7) of this section and including the ineffective portion of a hedge pair) must be assigned a 300 percent risk weight.

(6) *400 percent risk weight equity exposures.* An equity exposure (other than an equity exposure described in paragraph (b)(7) of this section that is not publicly-traded must be assigned a 400 percent risk weight.

(7) *600 percent risk weight equity exposures.* An equity exposure to an investment firm must be assigned a 600 percent risk weight, provided that the investment firm:

(i) Would meet the definition of a traditional securitization were it not for

the application of paragraph (8) of that definition; and

(ii) Has greater than immaterial leverage.

(c) *Hedge transactions.* (1) *Hedge pair.* A hedge pair is two equity exposures that form an effective hedge so long as each equity exposure is publicly-traded or has a return that is primarily based on a publicly-traded equity exposure.

(2) *Effective hedge.* Two equity exposures form an effective hedge if the exposures either have the same remaining maturity or each has a remaining maturity of at least three months; the hedge relationship is formally documented in a prospective manner (that is, before the [BANK] acquires at least one of the equity exposures); the documentation specifies the measure of effectiveness (E) the [BANK] will use for the hedge relationship throughout the life of the transaction; and the hedge relationship has an E greater than or equal to 0.8. A [BANK] must measure E at least quarterly and must use one of three alternative measures of E:

(i) Under the dollar-offset method of measuring effectiveness, the [BANK] must determine the ratio of value change (RVC). The RVC is the ratio of the cumulative sum of the changes in value of one equity exposure to the cumulative sum of the changes in the value of the other equity exposure. If RVC is positive, the hedge is not effective and E equals 0. If RVC is negative and greater than or equal to -1 (that is, between zero and -1), then E equals the absolute value of RVC. If RVC is negative and less than -1, then E equals 2 plus RVC.

(ii) Under the variability-reduction method of measuring effectiveness:

$$E = 1 - \frac{\sum_{t=1}^T (X_t - X_{t-1})^2}{\sum_{t=1}^T (A_t - A_{t-1})^2}, \text{ where}$$

(A)  $X_t = A_t - B_t$ ;

(B)  $A_t$  = the value at time t of one exposure in a hedge pair; and

(C)  $B_t$  = the value at time t of the other exposure in a hedge pair.

(iii) Under the regression method of measuring effectiveness, E equals the coefficient of determination of a regression in which the change in value of one exposure in a hedge pair is the dependent variable and the change in value of the other exposure in a hedge pair is the independent variable.

However, if the estimated regression coefficient is positive, then E equals zero.

(3) The effective portion of a hedge pair is E multiplied by the greater of the adjusted carrying values of the equity exposures forming a hedge pair.

(4) The ineffective portion of a hedge pair is (1 - E) multiplied by the greater of the adjusted carrying values of the equity exposures forming a hedge pair.

#### § \_\_\_\_.53 Equity exposures to investment funds.

(a) *Available approaches.* (1) Unless the exposure meets the requirements for a community development equity exposure under § \_\_\_\_.52(b)(3)(i), a [BANK] must determine the risk-weighted asset amount of an equity exposure to an investment fund under the Full Look-Through Approach described in paragraph (b) of this section, the Simple Modified Look-Through Approach described in

paragraph (c) of this section, or the Alternative Modified Look-Through Approach described paragraph (d) of this section.

(2) The risk-weighted asset amount of an equity exposure to an investment fund that meets the requirements for a community development equity exposure in § \_\_\_.52(b)(3)(i) is its adjusted carrying value.

(3) If an equity exposure to an investment fund is part of a hedge pair and the [BANK] does not use the Full Look-Through Approach, the [BANK] may use the ineffective portion of the hedge pair as determined under § \_\_\_.52(c) as the adjusted carrying value for the equity exposure to the investment fund. The risk-weighted asset amount of the effective portion of the hedge pair is equal to its adjusted carrying value.

(b) *Full Look-Through Approach.* A [BANK] that is able to calculate a risk-weighted asset amount for its proportional ownership share of each exposure held by the investment fund (as calculated under this subpart as if the proportional ownership share of each exposure were held directly by the [BANK]) may set the risk-weighted asset amount of the [BANK]'s exposure to the fund equal to the product of:

(1) The aggregate risk-weighted asset amounts of the exposures held by the fund as if they were held directly by the [BANK]; and

(2) The [BANK]'s proportional ownership share of the fund.

(c) *Simple Modified Look-Through Approach.* Under the Simple Modified Look-Through Approach, the risk-weighted asset amount for a [BANK]'s equity exposure to an investment fund equals the adjusted carrying value of the equity exposure multiplied by the highest risk weight that applies to any exposure the fund is permitted to hold under the prospectus, partnership agreement, or similar agreement that defines the fund's permissible investments (excluding derivative contracts that are used for hedging rather than speculative purposes and that do not constitute a material portion of the fund's exposures).

(d) *Alternative Modified Look-Through Approach.* Under the Alternative Modified Look-Through Approach, a [BANK] may assign the adjusted carrying value of an equity exposure to an investment fund on a pro rata basis to different risk weight categories under this subpart based on the investment limits in the fund's prospectus, partnership agreement, or similar contract that defines the fund's permissible investments. The risk-weighted asset amount for the [BANK]'s

equity exposure to the investment fund equals the sum of each portion of the adjusted carrying value assigned to an exposure type multiplied by the applicable risk weight under this subpart. If the sum of the investment limits for all exposure types within the fund exceeds 100 percent, the [BANK] must assume that the fund invests to the maximum extent permitted under its investment limits in the exposure type with the highest applicable risk weight under this subpart and continues to make investments in order of the exposure type with the next highest applicable risk weight under this subpart until the maximum total investment level is reached. If more than one exposure type applies to an exposure, the [BANK] must use the highest applicable risk weight. A [BANK] may exclude derivative contracts held by the fund that are used for hedging rather than for speculative purposes and do not constitute a material portion of the fund's exposures.

#### DISCLOSURES

#### § \_\_\_.61 Purpose and scope.

Sections \_\_\_.61–\_\_.63 of this subpart establish public disclosure requirements related to the capital requirements described in Subpart B for a [BANK] with total consolidated assets of \$50 billion or more that is not an advanced approaches [BANK] making public disclosures pursuant to § \_\_\_.172. Such a [BANK] must comply with § \_\_\_.62 of this part unless it is a consolidated subsidiary of a bank holding company, savings and loan holding company, or depository institution that is subject to these disclosure requirements or a subsidiary of a non-U.S. banking organization that is subject to comparable public disclosure requirements in its home jurisdiction. For purposes of this section, total consolidated assets are determined based on the average of the [BANK]'s total consolidated assets in the four most recent quarters as reported on the [REGULATORY REPORT]; or the average of the [BANK]'s total consolidated assets in the most recent consecutive quarters as reported quarterly on the [BANK]'s [REGULATORY REPORT] if the [BANK] has not filed such a report for each of the most recent four quarters.

#### § \_\_\_.62 Disclosure requirements.

(a) A [BANK] described in § \_\_\_.61 must provide timely public disclosures each calendar quarter of the information in the applicable tables in § \_\_\_.63. If a significant change occurs, such that the most recent reported amounts are no longer reflective of the [BANK]'s capital

adequacy and risk profile, then a brief discussion of this change and its likely impact must be disclosed as soon as practicable thereafter. Qualitative disclosures that typically do not change each quarter (for example, a general summary of the [BANK]'s risk management objectives and policies, reporting system, and definitions) may be disclosed annually, provided that any significant changes are disclosed in the interim. The [BANK]'s management is encouraged to provide all of the disclosures required by §§ \_\_\_.61 through \_\_\_.63 of this part in one place on the [BANK]'s public Web site.<sup>96</sup>

(b) A [BANK] described in § \_\_\_.61 must have a formal disclosure policy approved by the board of directors that addresses its approach for determining the disclosures it makes. The policy must address the associated internal controls and disclosure controls and procedures. The board of directors and senior management are responsible for establishing and maintaining an effective internal control structure over financial reporting, including the disclosures required by this subpart, and must ensure that appropriate review of the disclosures takes place. One or more senior officers of the [BANK] must attest that the disclosures meet the requirements of this subpart.

(c) If a [BANK] described in § \_\_\_.61 concludes that specific commercial or financial information that it would otherwise be required to disclose under this section would be exempt from disclosure by the [AGENCY] under the Freedom of Information Act (5 U.S.C. 552), then the [BANK] is not required to disclose that specific information pursuant to this section, but must disclose more general information about the subject matter of the requirement, together with the fact that, and the reason why, the specific items of information have not been disclosed.

#### § \_\_\_.63 Disclosures by [BANK]s described in § \_\_\_.61.

(a) Except as provided in § \_\_\_.62, a [BANK] described in § \_\_\_.61 must make the disclosures described in Tables 14.1 through 14.10 of this section. The [BANK] must make these disclosures publicly available for each of the last three years (that is, twelve quarters) or such shorter period beginning on the effective date of this subpart D.

<sup>96</sup> Alternatively, a [BANK] may provide the disclosures in more than one place, as some of them may be included in public financial reports (for example, in Management's Discussion and Analysis included in SEC filings) or other regulatory reports. The [BANK] must publicly provide a summary table that specifically indicates where all the disclosures may be found (for example, regulatory report schedules, page numbers in annual reports).

(b) A [BANK] must publicly disclose each quarter the following:  
 (1) Common equity tier 1 capital, additional tier 1 capital, tier 2 capital, tier 1 and total capital ratios, including the regulatory capital elements and all the regulatory adjustments and deductions needed to calculate the numerator of such ratios;

(2) Total risk-weighted assets, including the different regulatory adjustments and deductions needed to calculate total risk-weighted assets;  
 (3) Regulatory capital ratios during any transition periods, including a description of all the regulatory capital elements and all regulatory adjustments and deductions needed to calculate the

numerator and denominator of each capital ratio during any transition period; and  
 (4) A reconciliation of regulatory capital elements as they relate to its balance sheet in any audited consolidated financial statements.

TABLE 14.1—SCOPE OF APPLICATION

Qualitative Disclosures .....	(a) .....	The name of the top corporate entity in the group to which subpart D of this [PART] applies.
	(b) .....	A brief description of the differences in the basis for consolidating entities <sup>97</sup> for accounting and regulatory purposes, with a description of those entities: (1) That are fully consolidated; (2) That are deconsolidated and deducted from total capital; (3) For which the total capital requirement is deducted; and (4) That are neither consolidated nor deducted (for example, where the investment in the entity is assigned a risk weight in accordance with this subpart).
Quantitative Disclosures .....	(c) .....	Any restrictions, or other major impediments, on transfer of funds or total capital within the group.
	(d) .....	The aggregate amount of surplus capital of insurance subsidiaries included in the total capital of the consolidated group.
	(e) .....	The aggregate amount by which actual total capital is less than the minimum total capital requirement in all subsidiaries, with total capital requirements and the name(s) of the subsidiaries with such deficiencies.

<sup>97</sup> Entities include securities, insurance and other financial subsidiaries, commercial subsidiaries (where permitted), and significant minority equity investments in insurance, financial, and commercial entities.

TABLE 14.2—CAPITAL STRUCTURE

Qualitative Disclosures .....	(a) .....	Summary information on the terms and conditions of the main features of all regulatory capital instruments.
Quantitative Disclosures .....	(b) .....	The amount of common equity tier 1 capital, with separate disclosure of: (1) Common stock and related surplus; (2) Retained earnings; (3) Common equity minority interest; (4) AOCI; and (5) Regulatory deductions and adjustments made to common equity tier 1 capital.
	(c) .....	The amount of tier 1 capital, with separate disclosure of: (1) Additional tier 1 capital elements, including additional tier 1 capital instruments and tier 1 minority interest not included in common equity tier 1 capital; and (2) Regulatory deductions and adjustments made to tier 1 capital.
	(d) .....	The amount of total capital, with separate disclosure of: (1) Tier 2 capital elements, including tier 2 capital instruments and total capital minority interest not included in tier 1 capital; and (2) Regulatory deductions and adjustments made to total capital.

TABLE 14.3—CAPITAL ADEQUACY

Qualitative disclosures .....	(a) .....	A summary discussion of the [BANK]'s approach to assessing the adequacy of its capital to support current and future activities.
Quantitative disclosures .....	(b) .....	Risk-weighted assets for: (1) Exposures to sovereign entities; (2) Exposures to certain supranational entities and MDBs; (3) Exposures to depository institutions, foreign banks, and credit unions; (4) Exposures to PSEs; (5) Corporate exposures; (6) Residential mortgage exposures; (7) Statutory multifamily mortgages and pre-sold construction loans; (8) HVCRE loans; (9) Past due loans; (10) Other assets; (11) Cleared transactions; (12) Default fund contributions; (13) Unsettled transactions; (14) Securitization exposures; and (15) Equity exposures.
	(c) .....	Standardized market risk-weighted assets as calculated under subpart F of this [PART]. <sup>98</sup>

TABLE 14.3—CAPITAL ADEQUACY—Continued

	(d) .....	Common equity tier 1, tier 1 and total risk-based capital ratios: (1) For the top consolidated group; and (2) For each depository institution subsidiary.
	(e) .....	Total risk-weighted assets.

<sup>98</sup> Standardized market risk-weighted assets determined under subpart F are to be disclosed only for the approaches used.

TABLE 14.4—CAPITAL CONSERVATION BUFFER

Quantitative Disclosures .....	(a) .....	At least quarterly, the [BANK] must calculate and publicly disclose the capital conservation buffer as described under § __.11.
	(b) .....	At least quarterly, the [BANK] must calculate and publicly disclose the eligible retained income of the [BANK], as described under § __.11.
	(c) .....	At least quarterly, the [BANK] must calculate and publicly disclose any limitations it has on capital distributions and discretionary bonus payments resulting from the capital conservation buffer framework described under § __.11, including the maximum payout amount for the quarter.

**General Qualitative Disclosure Requirement**

For each separate risk area described in tables 14.5 through 14.10, the [BANK] must describe its risk management

objectives and policies, including: strategies and processes; the structure and organization of the relevant risk management function; the scope and nature of risk reporting and/or

measurement systems; policies for hedging and/or mitigating risk and strategies and processes for monitoring the continuing effectiveness of hedges/mitigants.

TABLE 14.5 <sup>99</sup>—CREDIT RISK: GENERAL DISCLOSURES

Qualitative Disclosures .....	(a) .....	The general qualitative disclosure requirement with respect to credit risk (excluding counterparty credit risk disclosed in accordance with Table 14.6), including the: (1) Policy for determining past due or delinquency status; (2) Policy for placing loans on nonaccrual; (3) Policy for returning loans to accrual status; (4) Definition of and policy for identifying impaired loans (for financial accounting purposes); (5) Description of the methodology that the [BANK] uses to estimate its allowance for loan losses, including statistical methods used where applicable; (6) Policy for charging-off uncollectible amounts; and (7) Discussion of the [BANK]'s credit risk management policy.
Quantitative Disclosures .....	(b) .....	Total credit risk exposures and average credit risk exposures, after accounting offsets in accordance with GAAP, without taking into account the effects of credit risk mitigation techniques (for example, collateral and netting not permitted under GAAP), over the period categorized by major types of credit exposure. For example, [BANK]s could use categories similar to that used for financial statement purposes. Such categories might include, for instance (1) Loans, off-balance sheet commitments, and other non-derivative off-balance sheet exposures, (2) Debt securities, and (3) OTC derivatives. <sup>100</sup>
	(c) .....	Geographic distribution of exposures, categorized in significant areas by major types of credit exposure. <sup>101</sup>
	(d) .....	Industry or counterparty type distribution of exposures, categorized by major types of credit exposure.
	(e) .....	By major industry or counterparty type: (1) Amount of impaired loans for which there was a related allowance under GAAP; (2) Amount of impaired loans for which there was no related allowance under GAAP; (3) Amount of loans past due 90 days and on nonaccrual; (4) Amount of loans past due 90 days and still accruing; <sup>102</sup> (5) The balance in the allowance for credit losses at the end of each period, disaggregated on the basis of the [BANK]'s impairment method. To disaggregate the information required on the basis of impairment methodology, an entity shall separately disclose the amounts based on the requirements in GAAP; and (6) Charge-offs during the period.
	(f) .....	Amount of impaired loans and, if available, the amount of past due loans categorized by significant geographic areas including, if practical, the amounts of allowances related to each geographical area <sup>103</sup> , further categorized as required by GAAP.
	(g) .....	Reconciliation of changes in ALLL. <sup>104</sup>
	(h) .....	Remaining contractual maturity delineation (for example, one year or less) of the whole portfolio, categorized by credit exposure.

<sup>99</sup> Table 14.5 does not cover equity exposures.

<sup>100</sup> See, for example, ASC Topic 815–10 and 210–20 (formerly FASB Interpretation Numbers 37 and 41).

<sup>101</sup> Geographical areas may consist of individual countries, groups of countries, or regions within countries. A [BANK] might choose to define the geographical areas based on the way the [BANK]'s portfolio is geographically managed. The criteria used to allocate the loans to geographical areas must be specified.

<sup>102</sup> A [BANK] is encouraged also to provide an analysis of the aging of past-due loans.

<sup>103</sup> The portion of the general allowance that is not allocated to a geographical area should be disclosed separately.

<sup>104</sup>The reconciliation should include the following: a description of the allowance; the opening balance of the allowance; charge-offs taken against the allowance during the period; amounts provided (or reversed) for estimated probable loan losses during the period; any other adjustments (for example, exchange rate differences, business combinations, acquisitions and disposals of subsidiaries), including transfers between allowances; and the closing balance of the allowance. Charge-offs and recoveries that have been recorded directly to the income statement should be disclosed separately.

TABLE 14.6—GENERAL DISCLOSURE FOR COUNTERPARTY CREDIT RISK-RELATED EXPOSURES

Qualitative Disclosures .....	(a) .....	The general qualitative disclosure requirement with respect to OTC derivatives, eligible margin loans, and repo-style transactions, including a discussion of: (1) The methodology used to assign credit limits for counterparty credit exposures; (2) Policies for securing collateral, valuing and managing collateral, and establishing credit reserves; (3) The primary types of collateral taken; and (4) The impact of the amount of collateral the [BANK] would have to provide given a deterioration in the [BANK]'s own creditworthiness.
Quantitative Disclosures .....	(b) .....	Gross positive fair value of contracts, collateral held (including type, for example, cash, government securities), and net unsecured credit exposure. <sup>105</sup> A [BANK] also must disclose the notional value of credit derivative hedges purchased for counterparty credit risk protection and the distribution of current credit exposure by exposure type. <sup>106</sup>
	(c) .....	Notional amount of purchased and sold credit derivatives, segregated between use for the [BANK]'s own credit portfolio and in its intermediation activities, including the distribution of the credit derivative products used, categorized further by protection bought and sold within each product group.

<sup>105</sup>Net unsecured credit exposure is the credit exposure after considering both the benefits from legally enforceable netting agreements and collateral arrangements without taking into account haircuts for price volatility, liquidity, etc.

<sup>106</sup>This may include interest rate derivative contracts, foreign exchange derivative contracts, equity derivative contracts, credit derivatives, commodity or other derivative contracts, repo-style transactions, and eligible margin loans.

TABLE 14.7—CREDIT RISK MITIGATION<sup>107 108</sup>

Qualitative Disclosures .....	(a) .....	The general qualitative disclosure requirement with respect to credit risk mitigation, including: (1) Policies and processes for collateral valuation and management; (2) A description of the main types of collateral taken by the [BANK]; (3) The main types of guarantors/credit derivative counterparties and their creditworthiness; and (4) Information about (market or credit) risk concentrations with respect to credit risk mitigation.
Quantitative Disclosures .....	(b) .....	For each separately disclosed credit risk portfolio, the total exposure that is covered by eligible financial collateral, and after the application of haircuts.
	(c) .....	For each separately disclosed portfolio, the total exposure that is covered by guarantees/credit derivatives and the risk-weighted asset amount associated with that exposure.

<sup>107</sup>At a minimum, a [BANK] must provide the disclosures in Table 14.7 in relation to credit risk mitigation that has been recognized for the purposes of reducing capital requirements under this subpart. Where relevant, [BANK]s are encouraged to give further information about mitigants that have not been recognized for that purpose.

<sup>108</sup>Credit derivatives that are treated, for the purposes of this subpart, as synthetic securitization exposures should be excluded from the credit risk mitigation disclosures and included within those relating to securitization (Table 14.8).

TABLE 14.8—SECURITIZATION

Qualitative Disclosures .....	(a) .....	The general qualitative disclosure requirement with respect to a securitization (including synthetic securitizations), including a discussion of: (1) The [BANK]'s objectives for securitizing assets, including the extent to which these activities transfer credit risk of the underlying exposures away from the [BANK] to other entities and including the type of risks assumed and retained with resecuritization activity; <sup>109</sup> (2) The nature of the risks (e.g. liquidity risk) inherent in the securitized assets; (3) The roles played by the [BANK] in the securitization process <sup>110</sup> and an indication of the extent of the [BANK]'s involvement in each of them; (4) The processes in place to monitor changes in the credit and market risk of securitization exposures including how those processes differ for resecuritization exposures; (5) The [BANK]'s policy for mitigating the credit risk retained through securitization and resecuritization exposures; and (6) The risk-based capital approaches that the [BANK] follows for its securitization exposures including the type of securitization exposure to which each approach applies.
	(b) .....	A list of: (1) The type of securitization SPEs that the [BANK], as sponsor, uses to securitize third-party exposures. The [BANK] must indicate whether it has exposure to these SPEs, either on- or off-balance sheet; and (2) Affiliated entities— (i) That the [BANK] manages or advises; and (ii) That invest either in the securitization exposures that the [BANK] has securitized or in securitization SPEs that the [BANK] sponsors. <sup>111</sup>
	(c) .....	Summary of the [BANK]'s accounting policies for securitization activities, including: (1) Whether the transactions are treated as sales or financings; (2) Recognition of gain-on-sale; (3) Methods and key assumptions applied in valuing retained or purchased interests;

TABLE 14.8—SECURITIZATION—Continued

		(4) Changes in methods and key assumptions from the previous period for valuing retained interests and impact of the changes; (5) Treatment of synthetic securitizations; (6) How exposures intended to be securitized are valued and whether they are recorded under subpart D; and (7) Policies for recognizing liabilities on the balance sheet for arrangements that could require the [BANK] to provide financial support for securitized assets.
Quantitative Disclosures .....	(d) .....	An explanation of significant changes to any quantitative information since the last reporting period.
	(e) .....	The total outstanding exposures securitized by the [BANK] in securitizations that meet the operational criteria provided in § __.41 (categorized into traditional and synthetic securitizations), by exposure type, separately for securitizations of third-party exposures for which the bank acts only as sponsor. <sup>112</sup>
	(f) .....	For exposures securitized by the [BANK] in securitizations that meet the operational criteria in § __.41: (1) Amount of securitized assets that are impaired/past due categorized by exposure type; <sup>113</sup> and (2) Losses recognized by the [BANK] during the current period categorized by exposure type. <sup>114</sup>
	(g) .....	The total amount of outstanding exposures intended to be securitized categorized by exposure type.
	(h) .....	Aggregate amount of: (1) On-balance sheet securitization exposures retained or purchased categorized by exposure type; and (2) Off-balance sheet securitization exposures categorized by exposure type.
	(i) .....	(1) Aggregate amount of securitization exposures retained or purchased and the associated capital requirements for these exposures, categorized between securitization and resecuritization exposures, further categorized into a meaningful number of risk weight bands and by risk-based capital approach (e.g., SSFA); and (2) Exposures that have been deducted entirely from tier 1 capital, credit enhancing I/Os deducted from total capital (as described in § __.42(a)(1), and other exposures deducted from total capital should be disclosed separately by exposure type.
	(j) .....	Summary of current year's securitization activity, including the amount of exposures securitized (by exposure type), and recognized gain or loss on sale by exposure type.
	(k) .....	Aggregate amount of resecuritization exposures retained or purchased categorized according to: (1) Exposures to which credit risk mitigation is applied and those not applied; and (2) Exposures to guarantors categorized according to guarantor credit worthiness categories or guarantor name.

<sup>109</sup> The [BANK] should describe the structure of resecuritizations in which it participates; this description should be provided for the main categories of resecuritization products in which the [BANK] is active.

<sup>110</sup> For example, these roles may include originator, investor, servicer, provider of credit enhancement, sponsor, liquidity provider, or swap provider.

<sup>111</sup> Such affiliated entities may include, for example, money market funds, to be listed individually, and personal and private trusts, to be noted collectively.

<sup>112</sup> "Exposures securitized" include underlying exposures originated by the bank, whether generated by them or purchased, and recognized in the balance sheet, from third parties, and third-party exposures included in sponsored transactions. Securitization transactions (including underlying exposures originally on the bank's balance sheet and underlying exposures acquired by the bank from third-party entities) in which the originating bank does not retain any securitization exposure should be shown separately but need only be reported for the year of inception. Banks are required to disclose exposures regardless of whether there is a capital charge under Pillar 1.

<sup>113</sup> Include credit-related other than temporary impairment (OTTI).

<sup>114</sup> For example, charge-offs/allowances (if the assets remain on the bank's balance sheet) or credit-related OTTI of I/O strips and other retained residual interests, as well as recognition of liabilities for probable future financial support required of the bank with respect to securitized assets.

TABLE 14.9—EQUITIES NOT SUBJECT TO SUBPART F OF THIS [PART]

Qualitative Disclosures .....	(a) .....	The general qualitative disclosure requirement with respect to equity risk for equities not subject to subpart F of this [PART], including: (1) Differentiation between holdings on which capital gains are expected and those taken under other objectives including for relationship and strategic reasons; and (2) Discussion of important policies covering the valuation of and accounting for equity holdings not subject to subpart F of this [PART]. This includes the accounting techniques and valuation methodologies used, including key assumptions and practices affecting valuation as well as significant changes in these practices.
	(b) .....	Value disclosed on the balance sheet of investments, as well as the fair value of those investments; for securities that are publicly-traded, a comparison to publicly-quoted share values where the share price is materially different from fair value.
Quantitative Disclosures .....	(c) .....	The types and nature of investments, including the amount that is: (1) Publicly-traded; and (2) Non publicly-traded.
	(d) .....	The cumulative realized gains (losses) arising from sales and liquidations in the reporting period.
	(e) .....	(1) Total unrealized gains (losses). <sup>115</sup> (2) Total latent revaluation gains (losses). <sup>116</sup>

TABLE 14.9—EQUITIES NOT SUBJECT TO SUBPART F OF THIS [PART]—Continued

	(f) .....	(3) Any amounts of the above included in tier 1 or tier 2 capital. Capital requirements categorized by appropriate equity groupings, consistent with the [BANK]'s methodology, as well as the aggregate amounts and the type of equity investments subject to any supervisory transition regarding regulatory capital requirements.
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<sup>115</sup> Unrealized gains (losses) recognized on the balance sheet but not through earnings.

<sup>116</sup> Unrealized gains (losses) not recognized either on the balance sheet or through earnings.

TABLE 14.10—INTEREST RATE RISK FOR NON-TRADING ACTIVITIES

Qualitative disclosures .....	(a) .....	The general qualitative disclosure requirement, including the nature of interest rate risk for non-trading activities and key assumptions, including assumptions regarding loan prepayments and behavior of non-maturity deposits, and frequency of measurement of interest rate risk for non-trading activities.
Quantitative disclosures .....	(b) .....	The increase (decline) in earnings or economic value (or relevant measure used by management) for upward and downward rate shocks according to management's method for measuring interest rate risk for non-trading activities, categorized by currency (as appropriate).

[End of Proposed Common Rule Text]

**List of Subjects**

*12 CFR Part 3*

Administrative practices and procedure, Capital, National banks, Reporting and recordkeeping requirements, Risk.

*12 CFR Part 217*

Banks, banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

*12 CFR Part 325*

Administrative practice and procedure, Banks, banking, Capital Adequacy, Reporting and recordkeeping requirements, Savings associations, State non-member banks.

**Adoption of Proposed Common Rule**

The adoption of the proposed common rules by the agencies, as modified by agency-specific text, is set forth below:

**DEPARTMENT OF THE TREASURY**

**Office of the Comptroller of the Currency**

12 CFR Chapter I

**Authority and Issuance**

For the reasons set forth in the common preamble and under the authority of 12 U.S.C. 93a and 5412(b)(2)(B), the Office of the Comptroller of the Currency proposes to further amend part 3 of chapter I of title 12, Code of Federal Regulations as proposed to be amended elsewhere in this issue of the **Federal Register** under Docket IDs OCC–2012–0008 and OCC–2012–0010, as follows:

**PART 3—MINIMUM CAPITAL RATIOS; ISSUANCE OF DIRECTIVES**

1. The authority citation for part 3 is revised to read as follows:

**Authority:** 12 U.S.C. 93a, 161, 1462, 1462a, 1463, 1464, 1818, 1828(n), 1828 note, 1831n note, 1835, 3907, 3909, and 5412(b)(2)(B).

2. Designate the text set forth at the end of the common preamble as subpart D of part 3.

3. Newly designated subpart D is amended as set forth below:

i. Remove “[AGENCY]” and add “OCC” in its place, wherever it appears;

ii. Remove “[BANK]” and add “national bank or Federal savings association” in its place, wherever it appears;

iii. Remove “[BANK]s” and add “national banks and Federal savings associations” in its place, wherever it appears;

iv. Remove “[BANK]’s” and add “national bank’s and Federal savings association’s” in its place, wherever it appears;

v. Remove “[PART]” and add “Part 3” in its place, wherever it appears; and

vi. Remove “[REGULATORY REPORT]” and add “Call Report” in its place, wherever it appears.

**Board of Governors of the Federal Reserve System**

12 CFR Chapter II

**Authority and Issuance**

For the reasons set forth in the common preamble, part 217 of chapter II of title 12 of the Code of Federal Regulations is proposed to be amended as follows:

**PART 217—CAPITAL ADEQUACY OF BANK HOLDING COMPANIES, SAVINGS AND LOAN HOLDING COMPANIES, AND STATE MEMBER BANKS (REGULATION Q)**

1. The authority citation for part 217 continues to read as follows:

**Authority:** 12 U.S.C. 248(a), 321–338a, 481–486, 1462a, 1467a, 1818, 1828, 1831n, 1831o, 1831p–l, 1831w, 1835, 1844(b), 3904, 3906–3909, 4808, 5365, 5371.

2. Subpart D is added as set forth at the end of the common preamble.

3. Subpart D is amended as set forth below:

a. Remove “[AGENCY]” and add “Board” in its place wherever it appears.

b. Remove “[BANK]” and add “Board-regulated institution” in its place wherever it appears.

c. Remove “[BANK]s” and add “Board-regulated institutions” in its place, wherever it appears;

d. Remove “[BANK]’s” and add “Board-regulated institution’s” in its place, wherever it appears;

e. Remove “[REGULATORY REPORT]” wherever it appears and add in its place “Consolidated Reports of Condition and Income (Call Report), for a state member bank, or the Consolidated Financial Statements for Bank Holding Companies (FR Y–9C), for a bank holding company or savings and loan holding company, as applicable” the first time it appears and “Call Report, for a state member bank, or FR Y–9C, for a bank holding company or savings and loan holding company, as applicable” every time thereafter;

f. Remove “[PART]” and add “part” in its place wherever it appears.

4. In § 217.30, revise paragraph (b)(1)(i) to read as follows:

§ 217.30 Applicability.

\* \* \* \* \*
(b) \* \* \*
(1) \* \* \*

(i) The methodology described in the general risk-based capital rules under 12 CFR part 208, appendix A, 12 CFR part 225, appendix A (Board); or

\* \* \* \* \*

5. In § 217.32, revise paragraphs (g)(3)(ii)(B), (k) introductory text, (l)(1) and (l)(6) introductory text, and add new paragraph (m) to read as follows:

§ 217.32 General risk weights.

\* \* \* \* \*
(g) \* \* \*
(3) \* \* \*
(ii) \* \* \*

(B) A Board-regulated institution must base all estimates of a property's value on an appraisal or evaluation of the property that satisfies subpart E of 12 CFR part 208.

\* \* \* \* \*

(k) Past due exposures. Except for an exposure to a sovereign entity or a residential mortgage exposure or a policy loan, if an exposure is 90 days or more past due or on nonaccrual:

\* \* \* \* \*

(l) Other assets. (1)(i) A bank holding company or savings and loan holding company must assign a zero percent risk weight to cash owned and held in all offices of subsidiary depository institutions or in transit, and to gold bullion held in a subsidiary depository institution's own vaults, or held in another depository institution's vaults on an allocated basis, to the extent the gold bullion assets are offset by gold bullion liabilities.

(ii) A state member bank must assign a zero percent risk weight to cash owned and held in all offices of the state member bank or in transit; to gold bullion held in the state member bank's own vaults or held in another depository institution's vaults on an allocated basis, to the extent the gold bullion assets are offset by gold bullion liabilities; and to exposures that arise from the settlement of cash transactions (such as equities, fixed income, spot foreign exchange and spot commodities) with a central counterparty where there is no assumption of ongoing counterparty credit risk by the central counterparty after settlement of the trade and associated default fund contributions.

\* \* \* \* \*

(6) Notwithstanding the requirements of this section, a state member bank may assign an asset that is not included in one of the categories provided in this section to the risk weight category

applicable under the capital rules applicable to bank holding companies and savings and loan holding companies under this part, provided that all of the following conditions apply:

\* \* \* \* \*

(m) Other—insurance assets—(1) Assets held in a separate account. (i) A bank holding company or savings and loan holding company must risk-weight the individual assets held in a separate account that does not qualify as a non-guaranteed separate account as if the individual assets were held directly by the bank holding company or savings and loan holding company.

(ii) A bank holding company or savings and loan holding company must assign a zero percent risk weight to an asset that is held in a non-guaranteed separate account.

(2) Policy loans. A bank holding company or savings and loan holding company must assign a 20 percent risk weight to a policy loan.

6. In § 217. 42, revise paragraph (h)(1)(iv) to read as follows:

§ 217.42 Risk-weighted assets for securitization exposures.

\* \* \* \* \*

(h) \* \* \*

(1) \* \* \*

(iv) In the case of a state member bank, the bank is well capitalized, as defined in 12 CFR 208.43. For purposes of determining whether a state member bank is well capitalized for purposes of this paragraph, the state member bank's capital ratios must be calculated without regard to the capital treatment for transfers of small-business obligations under this paragraph.

(B) In the case of a bank holding company or savings and loan holding company, the bank holding company or savings and loan holding company is well capitalized, as defined in 12 CFR 225.2. For purposes of determining whether a bank holding company or savings and loan holding company is well capitalized for purposes of this paragraph, the bank holding company or savings and loan holding company's capital ratios must be calculated without regard to the capital treatment for transfers of small-business obligations with recourse specified in paragraph (k)(1) of this section.

\* \* \* \* \*

7. In § 217.52, revise paragraph (b)(3)(i) to read as follows:

§ 217.52 Simple risk-weight approach (SRWA).

\* \* \* \* \*

(b) \* \* \*

(3) \* \* \*

(i) Community development equity exposures.

(A) For state member banks and bank holding companies, an equity exposure that qualifies as a community development investment under 12 U.S.C. 24 (Eleventh), excluding equity exposures to an unconsolidated small business investment company and equity exposures held through a consolidated small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682).

(B) For savings and loan holding companies, an equity exposure that is designed primarily to promote community welfare, including the welfare of low- and moderate-income communities or families, such as by providing services or employment, and excluding equity exposures to an unconsolidated small business investment company and equity exposures held through a small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682).

\* \* \* \* \*

Federal Deposit Insurance Corporation

12 CFR Chapter III

Authority and Issuance

For the reasons set forth in the common preamble, the Federal Deposit Insurance Corporation proposes to amend part 324 of chapter III of title 12 of the Code of Federal Regulations as follows:

PART 324—CAPITAL ADEQUACY

1. The authority citation for part 324 continues to read as follows:

Authority: 12 U.S.C. 1815(a), 1815(b), 1816, 1818(a), 1818(b), 1818(c), 1818(t), 1819(Tenth), 1828(c), 1828(d), 1828(i), 1828(m), 1828(o), 1831o, 1835, 3907, 3909, 4808; 5371; 5412; Pub. L. 102-233, 105 Stat. 1761, 1789, 1790 (12 U.S.C. 1831n note); Pub. L. 102-242, 105 Stat. 2236, 2355, as amended by Pub. L. 103-325, 108 Stat. 2160, 2233 (12 U.S.C. 1828 note); Pub. L. 102-242, 105 Stat. 2236, 2386, as amended by Pub. L. 102-550, 106 Stat. 3672, 4089 (12 U.S.C. 1828 note); Pub. L. 111-203, 124 Stat. 1376, 1887 (15 U.S.C. 78o-7 note).

2. Subpart D is added as set forth at the end of the common preamble.

3. Subpart D is amended as set forth below:

a. Remove “[AGENCY]” and add “FDIC” in its place, wherever it appears;

b. Remove “[BANK]” and add “bank and state savings association” in its place, wherever it appears in the phrase “Each [BANK]” or “each [BANK]”;

c. Remove “[BANK]” and add “bank or state savings association” in its place,



wherever it appears in the phrase “A [BANK]”, “a [BANK]”, “The [BANK]”, or “the [BANK]”;

d. Remove “[BANK]S” and add “banks and state savings associations” in its place, wherever it appears;

e. Remove “[BANK]’S” and add “banks and state savings associations” in its place, wherever it appears;

f. Remove “[PART]” and add “Part 324” in its place, wherever it appears;

g. Remove “[REGULATORY REPORT]” and add “Consolidated Reports of Condition and Income (Call

Report)” in its place the first time it appears, and add “Call Report” in its place, wherever it appears every time thereafter.

Dated: June 11, 2012.

**Thomas J. Curry,**  
*Comptroller of the Currency.*

By order of the Board of Governors of the Federal Reserve System, July 3, 2012.

**Jennifer J. Johnson,**  
*Secretary of the Board.*

Dated at Washington, DC, this 12th day of June, 2012.

By order of the Board of Directors,  
Federal Deposit Insurance Corporation.

**Robert E. Feldman,**  
*Executive Secretary.*

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