FDIC

Federal Deposit Insurance Corporation
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Financial Institution Letter
FIL-24-2012
June 18, 2012

Regulatory Capital Rules:
Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule

Summary: The federal bank regulatory agencies (the agencies) have jointly issued the attached Notice of Proposed Rulemaking (proposed rule) that would amend the advanced approaches risk-based capital rules (advanced approaches rules) to incorporate revisions to the Basel capital framework published by the Basel Committee on Banking Supervision (BCBS), and would remove references to credit ratings, consistent with section 939A of the Dodd-Frank Act. It also would propose to apply the market risk capital rules to state savings associations.

Statement of Applicability to Institutions with Total Assets Under $1 Billion: This Financial Institution Letter is generally not applicable to banks with total assets less than $1 billion. The market risk rules would, however, apply to those institutions with trading assets and liabilities that exceed 10 percent of total assets.

Distribution:
FDIC-Supervised Banks (Commercial and Savings)

Suggested Routing:
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Related Topics:
Risk-Based Capital Rules
12 CFR Part 325
Basel III

Attachment:
Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rules; Market Risk Capital Rules

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Highlights

The proposed rule:

- Introduces a credit valuation adjustment (CVA) capital requirement to address a potential increase in CVA due to changes in counterparty credit spreads.
- Includes a revised treatment for transactions with central counterparties (CCP) whereby transactions conducted through a qualifying CCP would receive a more favorable capital treatment relative to those transactions conducted through a CCP.
- Removes the ratings-based and the internal assessment approaches from the securitization hierarchy and substitutes in their place a simplified supervisory formula approach (SSFA).
- Enhances requirements for the calculation of counterparty credit risk including additional requirements for the use of stressed inputs and enhanced stress testing analyses in the internal models methodology.
- Incorporates an increase in asset value correlation factor used to determine the capital requirement for certain wholesale exposure.
- Revise the market risk rules to apply it to state federal savings associations.

Key Aspects of the Proposed Rule on *Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements*

Overview

To address weaknesses in the existing capital framework that were manifest during the recent financial crisis, the BCBS introduced a series of revisions to the advanced approaches risk-based capital framework in *Enhancements to the Basel II framework* (BCBS enhancements) and *Basel III: A global regulatory framework for more resilient banks and banking systems* (Basel III). In this proposed rule, the agencies are proposing to implement the BCBS enhancements, as discussed below, in a manner that is consistent with the requirements of section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The proposed rule would revise the agencies' advanced approaches rules to improve and strengthen modeling standards, the treatment of counterparty credit risk and securitization exposures, as well as disclosure requirements. However, consistent with section 939A of the Dodd-Frank Act, the proposed rule would not include the BCBS enhancements to the ratings-based approach for securitization exposures because it relies on the use of credit ratings.

Summary of the Proposed Rule

Counterparty Credit Risk

Credit Valuation Adjustment (CVA) Capital Requirement

Consistent with Basel III, the proposed rule would require a bank to directly reflect CVA risk through an additional capital requirement. The CVA capital requirement is designed to address a potential increase in CVA due to changes in counterparty credit spreads.

Under the proposed rule a bank may use one of two approaches to determine its CVA capital requirement, an advanced or simple CVA approach. The advanced CVA approach is based on the VaR model used by a bank to calculate specific risk under the market risk rule. In contrast, the simple CVA approach is based on the use of a supervisory formula and internally estimated probability-of-default.

Exposures to Central Counterparties

To incentivize the use of central counterparties (CCPs) that satisfy internationally recognized standards for settling and clearing processes (that is, qualified central counterparties or QCCPs), the proposed rule also proposes a more risk-sensitive treatment for transactions with CCPs, consistent with Basel III. Under the proposed rule, transactions conducted through a QCCP would receive a more favorable capital treatment relative to those conducted through a CCP. Similarly, the proposed rule would establish a capital requirement for a bank's default fund contribution[1] to a CCP, with a more favorable capital treatment for default fund contributions to a QCCP relative to those to a CCP.

Wrong-Way Risk, Margin Period of Risk, and Stressed Inputs

The proposed rule would require a bank's risk-management processes to identify, monitor, and control wrong-way risk throughout the life of an exposure using stress testing and scenario analyses. In addition, the proposed rule would improve the internal models methodology (IMM), which is currently used by a bank to determine its capital requirement for counterparty credit risk under the advanced approaches rules, through additional requirements for the use of stressed inputs and enhanced stress testing analyses.

With respect to counterparty credit risk more generally, the proposal also would increase the holding period and margin period of risk that a bank may use to determine its capital requirement for repo-style transactions, over-the-counter derivatives, and eligible model loans to address liquidity concerns that arose in settling or closing-out collateralized transactions during the recent crisis.

Asset Value Correlation

To recognize the correlation among financial institutions to common risk factors, the agencies are proposing to incorporate the Basel III increase in the correlation factor used to determine the capital requirement for certain "wholesale" exposures—that is, exposures to highly leveraged entities such as hedge funds and financial guarantors as well as exposures to regulated financial institutions with consolidated assets of greater than or equal to $100 billion.

Securitizations and Disclosures

The BCBS enhancements amended the Basel internal ratings-based approach to require a banking organization to assign higher risk weights to resecuritization exposures than other, similarly rated securitization exposures. Consistent with the BCBS enhancements, the proposed rule would amend the supervisory formula approach in a manner that results in higher risk weights for resecuritization positions. The proposed rule also would revise the definition of eligible financial collateral to exclude certain instruments that performed poorly during the crisis, such as resecuritization exposures.

Consistent with Section 939A of the Dodd-Frank Act, the proposed rule would remove the ratings-based and the internal assessment approaches from the securitization hierarchy under the existing advanced approaches rules and substitute in their place a simplified supervisory formula approach (SSFA) (see the standardized approaches proposed rule for a more extensive discussion of the SSFA). The agencies are proposing to remove the internal assessment approaches because it was designed to produce results

[1] Default fund contributions refer to the funds contributed or commitments made by clearing members to a CCP's mutualized loss sharing arrangement. Default funds are also known as clearing deposits or guaranty funds.

similar to, and for supervisory purposes would be compared with, the ratings-based approach.

Consistent with the BCBS enhancements, the agencies are proposing certain other revisions to the securitization framework under the advanced approaches rules. Specifically, the proposed rule would broaden the definition of securitization to include an exposure that directly or indirectly references a securitization exposure. In addition, consistent with the BCBS amendments, the proposed rule would improve risk-management practices with respect to securitization exposures by requiring banking organizations subject to the advanced approaches rules to conduct more rigorous credit analysis prior to acquiring such exposures. The proposed rule also would require enhanced disclosure requirements related to securitization exposures.

Other Revisions to Remove Credit Ratings

The agencies are proposing to replace creditworthiness standards in current definitions of the advanced approaches rules that reference credit ratings. (For example, under the current advanced approaches rules the term "eligible double default guarantor" requires the guarantor of an exposure to be of investment grade credit rating status). In general, the ratings-based standards would be replaced with a new "investment grade" standard, which would be defined as a determination by the bank that an entity to which the bank has exposure through a loan or security, or the reference entity with respect to a credit derivative, has adequate financial capacity to satisfy all commitments under the exposure for the projected life of the investment. Such an entity would have an adequate capacity to meet financial commitments if its risk of default is low and full and timely repayment of principal is expected.

In addition, the agencies are proposing to revise the collateral haircut approach by removing references to credit ratings from the matrix used to determine the standard supervisory market price volatility haircuts applicable to certain forms of collateral. Under the proposed rule, the market price volatility haircut would be based, in part, on the risk weight applicable to collateral under the Standardized Approaches proposed rule.

Market Risk Rule

Consistent their new authorities under section 312 of the Dodd-Frank Act, the agencies are proposing to revise the agencies' market risk rules to apply to State and federal savings associations, as well as savings and loan holding companies. The Office of Thrift Supervision (OTS) did not implement the market risk capital rules for such institutions prior to its abolition under section 313 of the Dodd-Frank Act because, as a general matter, such institutions do not engage in trading activity to a substantial degree. However, the agencies believe that any savings association or savings and loan holding company whose trading activity grows to the extent that it meets the thresholds should hold capital commensurate with the risk of the trading activity and should have in place the prudential risk management systems and processes required under the market risk capital rule.