

**DATE:** May 28, 2008

**MEMORANDUM TO:** Board of Directors

**FROM:** Sandra L. Thompson, Director  
Division of Supervision and Consumer Protection

**SUBJECT:** Notice of Proposed Rulemaking regarding *Risk-Based Capital Guidelines: Capital Adequacy Guidelines; Standardized Framework; Proposed Rules and Notice*

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**Proposal:** That the Board of Directors of the Federal Deposit Insurance Corporation (FDIC) approve the publication of the attached notice of proposed rulemaking (NPR) titled *Risk-Based Capital Guidelines: Capital Adequacy Guidelines; Standardized Framework; Proposed Rules and Notice* for a 90-day public comment period. This NPR proposes the domestic implementation of a risk-based capital framework (standardized framework) that is broadly consistent with the standardized approach provided in the *International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Comprehensive Version* (Basel II Accord). If approved, the NPR would be published in the *Federal Register* on an interagency basis by the FDIC, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (together, the agencies).

The proposed rule would increase risk sensitivity by providing a greater number of risk-weight categories to which a bank would assign to exposures based on (i) the type of exposure; (ii) whether the exposure has an issue-specific, external, or inferred rating from a nationally recognized statistical rating organization (NRSRO); and (iii) the quality of the applicable rating. The proposal also would encourage improved risk management by permitting broader recognition of credit risk mitigants, such as collateral and guarantees, than is allowed under the general risk-based capital rules; and increase the risk-based capital requirement for certain off-balance sheet exposures. Unlike the general risk-based capital rules, the proposed rule would require banks to hold risk-based capital for operational risk. The standardized framework would be available on an optional basis for banks that are not required to use the Basel II advanced approaches rule to calculate their minimum risk-based capital requirement (non-core banks).

Non-core banks that do not elect to apply the standardized framework would remain under the general risk-based capital rules.

The NPR solicits comment on various aspects of the standardized framework, including the use of NRSRO credit ratings, applicability to subsidiary depository institutions, applicability to banks for which the advanced approaches final rule is mandatory (core banks), and options for credit risk mitigation and operational risk that are in the Basel II Accord but have not been included in this NPR.

Finally, while the NPR provides a new approach for determining risk-weighted assets, it does not change the definition of instruments that qualify as tier 1 and total capital and it reiterates the importance of the existing rules for Prompt Corrective Action and the leverage ratio.

**Recommendation:** That the Board approve the publication of this NPR for public comment.

Concur:

Sara A. Kelsey  
General Counsel



## I. Introduction

The FDIC Board of Directors is being asked to approve for publication in the *Federal Register* the attached NPR which would implement a new risk-based capital framework that is generally consistent with the standardized approach for credit risk and the basic indicator approach (BIA) for operational risk provided in the Basel II Accord.<sup>1</sup> This NPR is also consistent, where relevant, with the advanced approaches final rule the agencies published in the *Federal Register* on December 7, 2007.<sup>2</sup>

Initially, the agencies implemented only the most advanced approaches for credit and operational risk in the Basel II Accord in the United States. The advanced approaches final rule is mandatory for the largest U.S. banks (core banks) and optional for other banks. Banks that do not plan to adopt the advanced approaches due to the cost and complexity associated with implementation expressed concern that they would be at a competitive disadvantage compared to core banks. In response, the agencies issued the Basel IA NPR, which proposed a limited number of changes to the general risk-based capital rules to modestly increase risk sensitivity, while minimizing regulatory burden.<sup>3</sup> Many commenters on the Basel IA NPR requested the agencies implement the standardized approach in the Basel II Accord instead.

On July 20, 2007, the agencies agreed to issue a proposed rule that would provide all non-core banks with the option to adopt a standardized approach as provided in the Basel II Accord.<sup>4</sup> The agencies stated that this proposed rule would replace the earlier Basel IA NPR and would be finalized before core banks begin the first transition period year under the advanced approaches final rule. This NPR is in response to that interagency agreement.

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<sup>1</sup> Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Comprehensive Version*, June, 2006.

<sup>2</sup> 72 FR 62988 (December 7, 2007).

<sup>3</sup> 71 FR 77446 (December 26, 2006).

<sup>4</sup> FDIC PR-64-2007, Joint Release, "Banking Agencies Reach Agreement on Basel II Implementation," July 20, 2007.



The standardized framework outlined in this proposal would provide U.S. banks the option to calculate their risk-based capital requirement in a manner that is more risk sensitive than the general risk-based capital rules but is less complex than the advanced approaches final rule. If a bank decides to use the proposed standardized framework, all subsidiary depository institutions must also opt into the framework unless a depository institution notifies its primary Federal supervisor and that supervisor does not object to the depository institution's intent to remain under the general risk-based capital rules.

The proposed standardized framework focuses primarily on refining the approach to calculating risk-weighted assets and would not change the definition of tier 1 or total capital in the general risk-based capital rules. The deductions from capital, however, would differ for securitization and equity exposures. The standardized framework also would not change prompt corrective action (PCA) or the leverage ratio calculation.

This proposal groups a bank's exposures into three basic categories: general credit, securitization, and equity. To calculate the risk-weighted assets for exposures in these categories, a bank would determine the appropriate exposure amount and multiply that amount by the appropriate risk weight based on the obligor and taking into account any collateral or guarantee. The general risk-based capital rules permit the use of NRSRO credit ratings only for securitization exposures and the ratings must be for specific issues. In contrast, the standardized framework generally would risk weight most types of exposures based on external or inferred ratings or the absence thereof.

Most general credit exposures would use the lowest issue-specific rating or, if there is no issue-specific rating, the issuer credit ratings from NRSROs as follows:

- (1) Exposures to a sovereign entity - the lowest issue-specific rating, otherwise the lowest issuer rating.
- (2) Exposures to a depository institution, foreign bank, or credit union - one risk weight lower than the risk weight that corresponds to the lowest issuer rating of the sovereign entity where the entity is incorporated or chartered.



- (3) Exposures to a public sector entity (PSE) - the lowest long-term issue-specific rating, otherwise the lowest inferred rating.
- (4) Corporate exposures - the lowest issue-specific rating (short- or long-term), otherwise the lowest inferred rating based on a long-term or issuer rating.

Risk weights for other general credit exposures would be assigned as follows, provided the exposures met the requirements specified in the proposed rule:

- (1) Exposures to a supranational entity and certain multilateral development banks (MDBs) would receive a zero percent risk weight.
- (2) Regulatory retail exposures would receive a 75 percent risk weight.
- (3) Residential mortgage exposure risk weights would range between 20 percent and 150 percent based on the loan-to-value (LTV) ratio of the mortgage exposure.
- (4) Past due loans would typically receive a 150 percent risk weight.
- (5) Assets not specified elsewhere would receive the same risk weights as under the general risk-based capital rules (100 percent risk weight).
- (6) Off-balance sheet exposures would be multiplied by the appropriate credit conversion factor to get the exposure amount. The exposure amount would be risk weighted based on the general credit exposure category. The credit conversion factor for short-term commitments that are not unconditionally cancelable would increase from zero percent to 20 percent.
- (7) Over-the-counter (OTC) derivative contracts are generally treated the same as under the general risk-based capital rules but the risk weight is no longer capped at 50 percent.
- (8) Guarantees and credit derivatives are significantly expanded to include additional counterparties and a counterparty credit charge would be instituted for certain credit derivatives.
- (9) Unsettled transactions would receive a capital charge for certain unsettled transactions in the same manner as the advanced approaches final rule.

In contrast to the general risk-based capital rules but consistent with the advanced approaches final rule, this NPR provides a risk-based capital requirement for the counterparty



credit risk of repo-style transactions. For securitization and equity exposures, the risk-based capital treatment is similar to the advanced approaches final rule. Consistent with the Basel II Accord, the proposed rule also includes a risk-based capital requirement for operational risk based on the Basic Indicator Approach (BIA). Furthermore, the proposed rule requires additional disclosures on all aspects of the standardized framework. Neither of these provisions is incorporated in the general risk-based capital rules.

## **II. The Basel II Accord and U.S. Rulemaking Process**

### **A. Background**

In June 2006, the Basel Committee released the Basel II Accord, which provided a new capital adequacy framework designed to promote improved risk-measurement and management processes and better align minimum risk-based capital requirements with risk. The Basel II Accord presents three approaches for calculating the risk-based capital requirements for credit risk (standardized, foundation internal ratings-based, and advanced internal ratings-based) and three approaches for operational risk (basic indicator, standardized, and advanced measurement).

On September 25, 2006, the agencies issued a notice of proposed rulemaking to implement the advanced approaches provided in the Basel II Accord. This advanced approaches NPR included the advanced internal ratings-based approach for credit risk and the advanced measurement approach for operational risk and was mandatory for the largest U.S. banks (core banks). The implementation of the advanced approaches NPR would have created a bifurcated regulatory capital framework in the United States, one set of risk-based capital rules for core banks, and another set for banks that do not use the advanced approaches final rule (general banks). On December 26, 2006, the agencies issued a notice of proposed rulemaking (the Basel IA NPR), which was designed to enhance the risk sensitivity of the general risk-based capital rules and address some of the competitive equity issues. Many of the comments on the advanced approaches NPR and the Basel IA NPR urged the agencies to implement the standardized approach provided in the Basel II Accord. The commenters generally believed that implementing the standardized approach would improve the risk-sensitivity of the risk-based



capital rules and appropriately address the industry's domestic and international competitive concerns.

Shortly before the publication of the advanced approaches final rule, the agencies announced their intention to propose for implementation in the United States the standardized approach to credit risk and the BIA for operational risk, as provided in the Basel II Accord.

## **B. The Proposed Rule**

This NPR includes most aspects of the standardized approach for credit risk, the basic indicator approach for operational risk, and the relevant disclosure requirements provided in the Basel II Accord. In certain instances, the NPR takes a different approach than the Basel II Accord to accommodate the unique characteristics and profile of the U.S. financial markets (most notably, residential mortgages), and to make the proposal consistent with the certain provisions of the advanced approaches final rule. Where the NPR differs from the Basel II Accord, the agencies believe that the differences are directionally consistent with the intent of the Accord and do not result in a substandard application of the Basel II Accord. If the NPR is published as a final rule, the agencies propose to codify the standardized framework as a separate appendix to each agency's respective capital rules (12 CFR Part 325, Appendix E for the FDIC).

This NPR does not propose to modify the leverage ratio or the capital components that make up tier 1 and total capital. The adjustments to tier 1 and total capital, however, would be modified to the extent that certain exposures would be deducted from capital or where the NPR proposes a new approach for the treatment of equity exposures. Under this NPR, any bank that must calculate a separate risk-based capital requirement for market risk, that is a bank with significant trading book exposures, would remain subject to the market risk rules (MRR).

## **Applicability of the Standardized Framework**

Under this NPR, any bank that does not use the advanced approaches final rule may use the standardized framework to calculate its risk-based capital requirement. If a bank holding



company decides to use the standardized framework, it must provide written notice to its primary Federal supervisor and all its subsidiary depository institutions must also opt in. Similarly, if a depository institution opts in to the standardized framework, its parent bank holding company (where applicable) and any subsidiary depository institutions of the parent holding company generally would be required to apply the standardized rules as well. The only exceptions would be for those subsidiary depository institutions that notify their primary Federal supervisor in writing of their intent not to opt in. As long as the primary Federal supervisor does not object, such depository institutions would not have to use the standardized framework.

The agencies received a significant number of comments from various banks, trade groups, and industry observers that all banks should be allowed to use the standardized approach. As proposed, the standardized framework generally would be available only to banks that are not core banks. The agencies are, however, seeking comment in the NPR regarding the extent to which core banks should be permitted to use the proposed standardized framework.

### **External and Inferred Ratings**

The standardized framework relies directly on the use of external credit ratings to assess the credit risk associated with individual exposures to sovereign entities, public sector entities (PSEs), corporations and securitizations. The proposal limits the use of credit ratings to those issued by a nationally recognized statistical rating organization (NRSRO). An NRSRO is an entity that is registered with the Securities and Exchange Commission (SEC) under section 15E of the Securities Exchange Act of 1934 (15 U.S.C. 78o-7).<sup>5</sup>

Under this NPR, the applicable external rating is the lowest NRSRO credit rating that is assigned to a particular exposure. If an exposure does not have an applicable external rating (unrated exposure), but another exposure of the obligor or the obligor itself has an external or issuer rating, then the bank must infer a rating based upon the externally rated exposure, the

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<sup>5</sup> See 17 CFR 240.17g-1. On September 29, 2006, the President signed the Credit Rating Agency Reform Act of 2006 ("Reform Act") (Pub. L. No. 109-291) into law. The Reform Act requires a credit rating agency that wants to represent itself as an NRSRO to register with the SEC. The agencies may review their risk-based capital rules, guidance and proposals from time to time to determine whether any modification of the agencies' definition of an NRSRO is appropriate.



obligor's issuer rating or both. In this case, the applicable inferred rating is the lowest of these inferred ratings. Generally, under this NPR, an exposure receives a risk weight based on its applicable external or applicable inferred rating or the absence thereof.

The applicable rating for a securitization exposure is also based on the lowest external or inferred rating but the use of unsolicited ratings is limited to instances where there is only one external rating. A securitization exposure that has no applicable rating exposure is generally deducted from either tier 1 or total capital, depending upon the type of exposure. The NPR also proposes to use NRSRO ratings indirectly to risk weight exposures to depository institutions, foreign banks, and credit unions.

In light of the recent events in the credit markets and related concerns with NRSRO ratings, the NPR seeks comment on the use of NRSRO ratings for risk-based capital purposes generally, on the question of solicited versus unsolicited ratings specifically, and on using ratings for securitization exposures. The agencies will consider revisions as necessary to remedy any deficiencies in the proposed and existing risk-based capital rules. The agencies are also particularly interested in comments on the use of external ratings for determining risk-based capital requirements. Recent losses on certain complex, well-rated securities illustrated that some investors, including some banks, may have placed excessive reliance on NRSRO ratings. In some cases, purchasers of these rated securities had access only to a general description of underlying collateral, which made pre-purchase assessments of whether these securities conformed to an institution's risk tolerances difficult or impossible. Banks holding these securities benefited from favorable risk weights in part because access to information about underlying collateral, or an independent risk assessment, has not been an operational precondition for banks to use a ratings-based capital treatment.

In March, the President's Working Group on Financial Markets (PWG) issued its *Policy Statement on Financial Market Developments*, which provides an analysis of the underlying factors contributing to the recent market stress and a set of recommendations to address identified weaknesses. Among its recommendations, the PWG encouraged regulators, including the Federal banking agencies, to review the current use of ratings in regulation and supervisory



rules. The PWG policy statement also acknowledged the steps already taken by credit rating agencies and encouraged additional actions, including the possible need to publish sufficient information about the assumptions underlying their credit rating methodologies; make changes to the credit rating process to clearly differentiate ratings for structured products from ratings for corporate and municipal securities; and make ratings performance measures for structured credit products and other asset-backed securities readily available to the public in a manner that facilitates comparisons across products and credit ratings.

Most directly relevant to this NPR, the agencies were encouraged to reinforce steps taken by the credit rating agencies through revisions to supervisory policy and regulation, including regulatory capital requirements that rely on NRSRO ratings. At a minimum, regulators were urged to distinguish, as appropriate, between ratings of structured credit products and ratings of corporate and municipal bonds in regulatory and supervisory policies. In the NPR, the agencies seek comment on how best to reflect the recommendations in the PWG Policy Statement in the use of external ratings in establishing risk-based capital requirements and any suggestions for changing or enhancing this NPR. The agencies also seek comment on any additional refinements to this NPR that would address more broadly the prudent use of NRSRO ratings by banks, including operational conditions related to the use of NRSRO ratings for certain securities, and enhancements to minimum capital requirements and the supervisory review process.

### **Risk Weighted Assets for General Credit Risk**

*Exposures to Sovereign Entities, PSEs, and Corporates.* In the NPR, the applicable external or applicable inferred rating is the basis for determining the risk weight of an exposure to a sovereign entity, an exposure to a public-sector entity (PSE), or a corporate exposure (which includes exposures to a securities broker or dealer or an exposure to a government-sponsored enterprise (GSE)). For those exposures, the applicable rating generally corresponds to a risk weight that is inversely related to the quality of the NRSRO rating.



**Table 1 – Exposures to Sovereign Entities, PSEs, and Corporates**

Applicable External or Applicable Inferred Rating	Example	Risk Weight (in percent)		
		Sovereign	PSE	Corporate
Highest investment grade rating	AAA	0	20	20
Second-highest investment grade rating	AA	0	20	20
Third-highest investment grade rating	A	20	50	50
Lowest-investment grade rating	BBB	50	50	100
One category below investment grade	BB	100	100	100
Two categories below investment grade	B	100	100	150
Three categories or more below investment grade	CCC	150	150	150
No applicable rating	N/A	100	50	100

**Table 2 – Short-term Corporates**

Applicable external rating	Example	Risk Weight (in percent)
Highest investment grade	A-1/P-1	20
Second-highest investment grade	A-2/P-2	50
Third-highest investment grade	A-3/P-3	100
Below investment grade	B, C, and non-prime	150
No applicable external rating	NA	100

***Exposures to Supranationals and Multilateral Development Banks:*** Exposures to certain supranationals and multilateral development banks would be risk weighted at zero percent.

***Exposures to Depository Institutions, Foreign Banks and Credit Unions.*** For exposures to depository institutions, foreign banks, and credit unions, the risk weight is one step higher than the risk weight for the sovereign where the entity is incorporated. For example, the risk weight for an exposure to a U.S. depository institution would be 20 percent, which is one step higher than the zero percent risk weight accorded exposures to the United States, which has an issuer



rating of AAA. This risk weight is consistent with the risk weight for exposures to U.S. depository institutions in the general risk-based capital rules.

The Basel II Accord provides two options for risk-weighting depository institutions and PSEs. The NPR proposes one approach for depository institutions (based on the risk weight of the sovereign entity) and a different approach for PSEs (based on the issue rating). The NPR seeks comment on whether the approach proposed for PSEs should be applied to depository institutions and whether the approach for depository institutions should be applied to PSEs.

***Residential Mortgage Exposures.*** The proposed rule uses LTV ratios to risk weight one-to-four family residential mortgages similar to the method that was proposed in the Basel IA NPR. Although the Basel II Accord provides a 35 percent risk weight for most residential mortgages the agencies believe that more a robust and risk-sensitive framework is appropriate in the United States. The agencies believe that LTV ratios are a simple and straightforward method to differentiate risk and the likelihood of borrower default. Thus, depending upon an individual mortgage's LTV ratio, it may be assigned a risk weight that is either greater than or less than the 35 percent risk weight provided in the Basel II Accord. The proposed rule would not allow a residential mortgage to be assigned a risk weight that is lower than 20 percent or greater than 150 percent. Past due residential mortgages would receive a 100 or 150 percent risk weight based on the LTV ratio of the mortgage.

**First Lien Mortgages** - Under the proposed rule, a bank would use the risk weights in Table 3 for all first-lien mortgages or combined first and junior lien mortgages (for example, piggy-back loans) based upon the mortgage's LTV ratio. The LTV ratio would be determined for a mortgage at origination and the bank could not change the LTV ratio except as a result of loan amortization (positive or negative) or whenever a mortgage is restructured. For the purposes of determining the LTV ratio, a bank would be permitted to consider loan-level private mortgage insurance purchased from an insurer that is not affiliated with the bank, provided that the mortgage insurer has issued and outstanding long-term debt with an external rating within the top three external rating categories (that is, A- or better).



Junior Lien Mortgages - The agencies continue to believe that a stand-alone junior mortgage loans pose greater risk and necessitates a higher risk weight than a comparable first-lien mortgage. For a stand-alone junior lien mortgage, the proposed rule would require a bank to determine the combined LTV ratio calculated based on the amount of the first and junior liens. The bank would assign a risk weight according to Table 3 using the combined LTV of the loan. In addition, the proposed rule also requires a bank to hold risk-based capital for the unfunded portion of a home equity line of credit (HELOC) by applying the appropriate credit conversion factor and risk weight to the unfunded portion of the loan.

**Table 3 – Risk Weights of Residential Mortgage Exposures**

Loan to Value Ratio (in percent)	Risk Weights (in percent)	
	First-lien	Junior-lien
Less than or equal to 60	20	75
Greater than 60 and less than or equal to 80	35	100
Greater than 80 and less than or equal to 85	50	100
Greater than 85 and less than or equal to 90	75	100
Greater than 90 and less than or equal to 95	100	150
Greater than 95	150	150

Negative Amortization Features - Negative amortization features in a mortgage increase the credit risk exposure to a bank in the form of an unfunded commitment. Therefore, the NPR clarifies that mortgage loans with negative amortization features must be risk weighted consistently with the risk-based capital requirements for other assets with unfunded commitments (for example, lines of credit). Under the proposal, the unfunded maximum negative amortization amount would be risk weighted separately from the funded amount of the loan.

The NPR seeks comments on other risk-sensitive methods that could be used to segment residential mortgages by risk level. One such example would be using pricing information from the Home Mortgage Disclosure Act that most banks are currently required to report.



***Regulatory Retail Exposures, Past Due Loans, and Other Assets.*** Consistent with the Basel II Accord, this NPR provides a 75 percent risk weight for retail exposures (regulatory retail exposures), provided that the aggregate exposure amount to one obligor is no greater than \$1 million and the exposure meets other criteria. These exposures include, for example, credit card loans, personal loans, or small loans to businesses, but would not include residential mortgages, securitization or equity exposures. Under the general risk-based capital rules, these types of retail exposures generally receive a 100 percent risk weight.

Under this NPR, all non-residential mortgage exposures that are 90 days or more past due or on non-accrual must be risk weighted at 150 percent. Under the general risk-based capital rules, the risk weight of a loan generally does not change when the exposure becomes past due, with the exception of certain residential mortgage loans.

For a number of other asset categories, this NPR proposes to use the risk weights that are currently provided in the general risk-based capital rules. For example, a zero risk weight would apply to cash owned and held in a bank's offices or in transit and a 20 percent risk weight would apply to cash in the process of collection.

***Off-balance Sheet Exposures.*** Generally, this NPR proposes to treat off-balance sheet exposures in the same manner as under the general risk-based capital rules. The off-balance sheet exposure would be multiplied by a credit conversion factor (CCF) to determine the exposure amount for risk-based capital purposes. The CCFs would be the same as the CCFs in the general risk-based capital rules with the notable exception of short-term commitments that are not unconditionally cancelable. This NPR would apply a 20 percent CCF to these short-term commitments compared to a zero percent CCF under the general risk-based capital rules. The agencies believe that a 20 percent CCF for these short-term commitments better reflects the risk of these exposures.

***OTC Derivative Contracts.*** Consistent with the Basel II Accord and similar to the approach in the general risk-based capital rules, this NPR uses the current exposure method to determine the exposure amount for a single OTC derivative contract or multiple OTC derivative



contracts covered by a qualifying master netting agreement. To be recognized, a qualifying master netting agreement must satisfy certain requirements, which are consistent with the requirements provided in the advanced approaches final rule. If the OTC derivative contract is collateralized, a bank could recognize the credit risk mitigating benefits of any financial collateral using the simple or collateral haircut approaches proposed in the collateralized transactions section of this NPR.

Under the general risk-based capital rules, the risk weight for an OTC derivative contract is capped at 50 percent. Under this NPR and consistent with the Basel II Accord, that cap is removed and the risk weight would be the appropriate risk weight for the counterparty or obligor.

This NPR also describes the circumstances under which a risk-based capital requirement for counterparty credit risk for credit derivatives and equity derivatives is assessed.

### **Credit Risk Mitigation**

***Guarantees and Credit Derivatives.*** Consistent with the Basel II Accord and similar to the general risk-based capital rules and the advanced approaches final rule, a bank may substitute the risk weight of an eligible guarantor for the risk weight of the hedged or protected exposure. This NPR proposes to recognize a wider range of guarantors and protection providers than is allowed under the general risk-based capital rules. Consistent with the advanced approaches, eligible guarantor means a sovereign entity, certain supranational entities, certain government-sponsored enterprises, depository institutions, multilateral development banks, a bank or savings and loan holding company, or a foreign bank, as well as any other entity that has issued and has outstanding an unsecured long-term debt security without credit enhancement that has a long-term applicable external rating. The credit risk mitigation benefits of guarantees and credit derivatives are recognized to the extent that they satisfy certain eligibility requirements, which are consistent with the requirements provided in the advanced approaches final rule.

The proposed rule would treat conditional guarantees of the U.S. government or its agencies similar to unconditional guarantees, provided that the conditional nature of the



guarantee is dependent upon some affirmative action on the part of the beneficiary of the guarantee or a third party (for example, servicing requirements). As a result, many exposures that are guaranteed by U.S. government agencies, which currently receive a 20 percent risk weight, will receive a zero percent risk weight under the proposed rule. The agencies believe that the risks associated with conditional U.S. government guarantees are solely operational in nature and that appropriate capital is assessed under the operational risk charge.

A bank that recognizes the credit risk mitigation benefits of an eligible guarantee or eligible credit derivative would have to reduce the amount of the credit risk mitigant to reflect any maturity or currency mismatch. Similarly, the amount of an eligible credit derivative would be reduced if it does not include a restructuring as a credit event that triggers payment under the derivative.

***Collateralized Transactions.*** Consistent with the Basel II Accord and the advanced approaches final rule, this NPR proposes to expand the range of collateral that a bank may recognize (financial collateral). Subject to certain conditions, financial collateral would include long- and short-term debt instruments with applicable external ratings of at least BB- or A-3 respectively; publicly traded equity securities; certain money market mutual fund shares; and conforming residential mortgages, in addition to the collateral currently recognized under the general risk-based capital rules.

A bank could recognize the benefits of financial collateral for a particular type of collateralized transaction using one of several different approaches: the simple approach, which is essentially the approach currently available under the general risk-based capital rules; the collateral haircut approach, which includes supervisory haircuts that are specified in the NPR or with supervisory approval, a bank's estimates of haircuts; or the simple VaR approach. Consistent with the advanced approaches final rule, the collateral haircut approach may be used only for collateralized OTC derivative contracts, repo-style transactions, and eligible margin loans and the simple VaR approach may be used only for repo-style transactions and eligible margin loans. This NPR provides a more flexible approach than the Basel II Accord by permitting the use of any of the above approaches that are permissible to recognize collateral



provided the bank uses the same approach for similar exposures. Consistent with the advanced approaches final rule, the NPR also discusses risk management guidance for recognizing collateral.

In contrast to the Basel II Accord, the NPR does not propose the internal models approach, which includes the expected positive exposure approach (EPE) that allows cross-product netting for collateralized OTC derivative contracts, repo-style transactions, and eligible margin loans. The NPR seeks comment on whether the internal models approach as well as the so-called Zero H approach, both of which are contained in the Basel II Accord as an option within the standardized approach, should be included as an option in the U.S. standardized framework.

Under both the simple and collateral haircut approaches, a bank would have to calculate a counterparty risk-based capital requirement for certain capital market transactions such as repurchase, reverse repurchase, and securities lending and borrowing agreements. The general risk-based capital rules do not have this capital requirement.

***Definition of Securitization Exposures and Hedge Funds.*** Consistent with the advanced approaches final rule, the proposal generally defines a securitization exposure as an exposure that involves the tranching of credit risk associated with the financial assets underlying the securitization exposure. For example, a mortgage backed security that has a senior and one or more junior tranches as well as an equity or first loss tranche would qualify as a securitization exposure. In contrast, a pass-through mortgage backed security guaranteed by Freddie Mac or Fannie Mae that does not have tranching of risk would not be securitization exposure. The proposal also provides the primary Federal supervisor with discretion to exclude from the definition of securitization investment firms that exercise substantially unfettered control over the size and composition of their assets, liabilities, and off-balance sheet transactions (e.g., certain hedge funds and private equity funds).

***Treatment of Securitization Exposures.*** This proposed rule has a somewhat different treatment for securitization exposures than the general risk-based capital rules. It is, however,



generally similar to the ratings-based approach in the advanced approaches final rule with the exception of the range of risk weights. Under this NPR, a bank would deduct from capital all after-tax gain-on-sale and credit-enhancing interest-only strips resulting from the origination of securitization exposures. A bank would continue to risk weight the securitization exposure according to the external rating of the exposure; however, the risk weight of a BB-rated tranche would increase from 200 percent to 350 percent. The credit conversion factor for a short-term eligible asset-backed commercial paper (ABCP) liquidity facility also would increase from 10 percent to 20 percent, consistent with the proposed CCFs for other unfunded commitments. The agencies believe that these changes better align capital with the risks of securitization.

The proposed rule would assess a risk-based capital charge for securitizations of revolving exposures with early-amortization features (for example, credit card securitizations). Early amortization provisions in securitizations increase the likelihood that investors will be repaid before being subject to any risk of significant credit losses. The early amortization capital charge would be assessed against the off-balance sheet investors' interest and would be imposed only in the event that the excess spread has declined to a predetermined level. A maximum capital charge would prevent the total capital charge for these exposures from being greater than if the bank held the exposures on-balance sheet.

**Equity Exposures.** The proposed rule would risk weight equity exposures consistent with the Simple Risk Weight Approach (SRWA) in the advanced approaches final rule. This approach assigns risk weights between based on Table 4 below.

**Table 4 – Risk Weights for Equity Exposures**

Risk Weight (in percent)	Equity Exposure
0	An equity exposure to a sovereign entity, certain supranationals, and any other entity whose credit exposures receive a zero percent risk weight under this proposed rule.
20	An equity exposure to a Federal Home Loan Bank or Farmer Mac



Risk Weight (in percent)	Equity Exposure
100	Community development equity exposures, the effective portion of a hedge pair, and non-significant equity exposures (less than 10 percent of tier 1 plus tier 2 capital)
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 (1) would meet the definition of a traditional securitization were it not for the primary Federal supervisor's decision to remove it from the securitization framework and (2) has greater than immaterial leverage

Under the proposed rule a bank would determine the risk-weighted asset amount for equity exposures to investment funds using one of four approaches: the full look-through approach, the simple modified look-through approach, the alternative modified look-through approach, or for qualifying investment funds, the money market fund approach. Consistent with the advanced approaches final rule, certain money market mutual fund exposures could receive a risk weight of seven percent. These approaches allow banks to choose a more conservative method if the necessary data on the exposures is unavailable or it is less burdensome to obtain the relevant data.

**Operational Risk.** The proposed rule requires banks to determine the risk-based capital requirement for operational risk using the basic indicator approach (BIA). Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events. This definition also includes legal risk, which is the risk of loss (including litigation costs, settlements, and regulatory fines) resulting from the failure of the bank to comply with laws, regulations, prudent ethical standards, and contractual obligations in any aspect of the bank's business, but excludes strategic and reputational risks.

Under the BIA, a bank would calculate its risk-based capital requirement based on the average of the previous three years' positive gross income multiplied by 15 percent. A bank would exclude any year that gross income was negative or zero. Gross income would equal a



banks total net interest income plus non-interest income minus income from insurance and reinsurance activities. The capital requirement would be set at the beginning of the calendar year for the subsequent calendar year. For example, at year-end 2009, a bank would use gross income for 2007, 2008, and 2009 to calculate the capital requirement for all of 2010.

In the BIA, average positive gross income is used as a proxy for the measurement of operational risk. As a result, the lower a bank's gross income, the lower its operational risk charge would be. Thus, should a bank maintain a high risk profile, which yielded high income during periods of economic expansion and losses during periods of economic contraction, the bank would be assessed higher operational risk charges when the high-risk strategy was successful and lower operational risk charges when the strategy was unsuccessful. As a result, the agencies are concerned about the use of average positive income for determining operational risk charges and are seeking comment on alternative approaches.

In addition to the BIA, the Basel II Accord provides a more advanced approach, the advanced measurement approaches (AMA), for determining the operational risk capital requirement. The Basel II Accord presents the AMA as an option for banks using the advanced approaches and the standardized approach framework. Unlike the BIA, the AMA does not use gross income as a proxy for operational risk; rather, operational risk is assessed through the use of internal risk quantification systems. The NPR seeks comment on the appropriateness of the BIA and on whether a final rule should provide the AMA as an option for calculating the operational risk-based capital requirement.

***Total Risk-Based Capital Requirement.*** The total risk-based capital requirement for a bank under this proposal includes the amount of capital determined by the application of the standardized approach for credit risk and the amount determined for operational risk under the BIA and, for banks that use the market risk amendment, a market risk capital charge. The BCBS announced in May 2007 that it has launched an initiative to review the definition of regulatory capital due to advances in economic capital management and markets for capital instruments (and in particular, markets for hybrid capital instruments).

## **Pillar 2: Supervisory Oversight and Internal Capital Adequacy Assessment**



The second pillar of the Basel II Accord, supervisory review, describes several principles that highlight the need for banks to assess their capital adequacy positions relative to risk, and the need for supervisors to review and take appropriate actions in response to those assessments such as requiring additional buffer capital given the risk profile of the institution. While the NPR primarily focuses on the first pillar, minimum capital requirements, there are provisions within the proposed rule that would require supervisory review and an internal assessment of capital adequacy.

### **Pillar 3: Market Discipline**

The general risk-based capital rules do not require disclosures beyond the filing of the risk-based capital section of the agencies' regulatory reports (that is, FR Y9-C, Call Reports, TFR, etc). The agencies, however, have long supported meaningful public disclosure by banks with the objective of improving market discipline. The agencies recognize the importance of market discipline in encouraging sound risk management practices and fostering financial stability. Under the third pillar of the Basel II Accord, disclosure requirements are established to allow market participants to assess key information about an institution's risk profile and its associated level of capital, and provide for comparability of risk elements. Increased disclosures are intended to allow an institution's stakeholders to evaluate more fully the institution's financial condition, including its capital adequacy. This greater transparency is critical to the development of effective market discipline.

The proposal requires the top-tier legal entity at the consolidated level, either the top-tier banking holding company or depository institution, if not under a holding company structure, to make certain mandatory disclosures on a quarterly basis. In addition to disclosing risk-based capital ratios and their components, the reporting entity must also report other information that is designed to enable market participants to better evaluate the bank's capital structure, risk exposure, risk management performance, and capital adequacy. To further enhance transparency, the reporting entity is encouraged to post all disclosures made over the last three years in a single location on the bank's public website or some other readily accessible location.



The proposal requires each reporting entity to have a formal disclosure policy that is approved by the board of directors. This policy must provide for effective internal controls as well as disclosure controls and procedures to ensure that appropriate verification of the disclosure takes place.

The agencies are concerned that the disclosures required under Pillar 3 are not appropriate for all banks that may adopt the standardized framework in this NPR. For example, banks that are privately held and are not required to have audited financial statements may find that the burden exceeds the benefit of enhanced disclosure to other market participants. The agencies have included a comprehensive question regarding the applicability and proposed requirements of Pillar 3.