

November 18, 2014

MEMORANDUM TO: Board of Directors

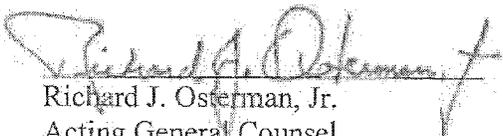
FROM: Doreen R. Eberley, Director 
Division of Risk Management Supervision

SUBJECT: Regulatory Capital Rules: Regulatory Capital, Proposed Revisions to the Advanced Approaches Risk-Based Capital Rule

Summary: In 2013, the Office of the Comptroller of the Currency (“OCC”), the Board of Governors of the Federal Reserve System (“FRB”), and the Federal Deposit Insurance Corporation (“FDIC”) (collectively, “the agencies”) comprehensively revised and strengthened the capital regulations applicable to banking organizations (the “2013 capital rule”). Staff now is seeking the approval of the FDIC Board of Directors (“FDIC Board”) to publish the attached interagency notice of proposed rulemaking (“NPR”) to clarify and amend certain aspects of the agencies’ 2013 capital rule that are applicable only to banking organizations subject to the advanced approaches framework in the 2013 capital rule.

Recommendation: That the FDIC Board approve the attached interagency NPR and authorize its publication in the *Federal Register* for a 60-day comment period.

Concur:


Richard J. Osterman, Jr.
Acting General Counsel

Discussion:

Background

The OCC, the FRB, and the FDIC issued the 2013 capital rule to revise and strengthen their leverage and risk-based capital rules.¹ Among other changes, the 2013 capital rule revised elements of the advanced approaches risk-based capital requirements in subpart E of the agencies' regulatory capital rules ("advanced approaches rule")². The advanced approaches rule applies to large, internationally active banking organizations ("advanced approaches banking organizations"), which generally includes those banking organizations with at least \$250 billion in total consolidated assets or at least \$10 billion in total on-balance sheet foreign exposure, as well as the depository institution subsidiaries of those firms and other firms that opt into the advanced approaches rules.³ Advanced approaches banking organizations are subject to the minimum capital requirements under section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which have been incorporated into the agencies' regulatory capital regulations.⁴

Before an advanced approaches banking organization may use the advanced approaches rule to determine its risk-based capital requirements, it must conduct a satisfactory trial, or parallel run.⁵ During the parallel run period of at least four consecutive quarters, an advanced approaches banking organization must demonstrate to the satisfaction of its primary Federal supervisor that it has implemented the risk-measurement and risk-management systems of the

¹ The FRB and the OCC issued a joint final rule on October 11, 2013 (78 FR 62018) and the FDIC issued a substantially identical interim final rule on September 10, 2013 (78 FR 55340). On April 8, 2014, the FDIC adopted the interim final rule as a final rule with no substantive changes. 79 FR 20754 (April 14, 2014).

² 12 CFR 324, subpart E.

³ 12 CFR 324.100(b)(1).

⁴ 12 U.S.C. 5371.

⁵ 12 CFR 324.121(c).

advanced approaches rule. If the primary Federal supervisor determines that the banking organization fully complies with all the qualification requirements, has conducted a satisfactory parallel run, and has an adequate process to ensure ongoing compliance, then the banking organization may calculate its risk-based capital requirements under the advanced approaches rule.⁶ In February, 2014, the OCC and FRB granted permission to a number of banking organizations to begin calculating their risk-based capital requirements under the advanced approaches rule, beginning first quarter 2014.⁷ During the parallel run review process, the agencies' identified several provisions of the 2013 capital rule that would benefit from additional clarification or amendment. These clarifications and amendments, discussed below, are also intended to enhance consistency of the U.S. regulations with international standards for use of the advanced approaches risk-based capital framework and are only applicable to advanced approaches banking organizations.

Proposed Rule

The proposed rule would make various clarifications and revisions to the advanced approaches rule in the 2013 capital rule. Included among these clarifications, the proposed rule would amend the definition of residential mortgage exposure. The 2013 capital rule inadvertently omits the provision that, for purposes of the advanced approaches rule, an exposure secured by a first or subsequent lien on a one-to-four family residential property must be managed as part of a segment of exposures with homogenous risk characteristics, and not on an individual basis.⁸ The proposed rule states that such an exposure must be managed as part of a

⁶ 12 CFR 324.121(d).

⁷ FRB Press Release <http://www.federalreserve.gov/newsevents/press/bcreg/20140221a.htm>.

⁸ This provision is explicit in the 2013 capital rule definition of residential mortgage exposures for an exposure with an original and outstanding amount of \$1 million or less that is primarily secured by a first or subsequent lien on residential property that is not one-to-four family.

segment of exposures with homogenous risk characteristics, and not on an individual basis, to be considered a residential mortgage exposure when determining regulatory capital requirements under the advanced approaches rule. This change would also make the definition consistent with the definition used in the 2007 advanced capital adequacy framework implementing Basel II⁹ (2007 rule).

The proposed rule would clarify section 22 of the 2013 capital rule, which requires that a banking organization adjust its common equity tier 1 capital for changes in the fair value of liabilities due to changes in the banking organization's own credit risk.¹⁰ How advanced approaches banking organizations effect this deduction under the 2013 capital rule is unclear and could be interpreted as requiring advanced approaches banking organizations to make the same deduction twice. The proposed rule would clarify the calculation of the adjustment for changes in the fair value of derivative liabilities due to changes in the advanced approaches banking organization's own credit risk.

In addition, the proposed rule would clarify sections 122 and 131 of the 2013 capital rule, which set forth the qualification requirements for the internal ratings-based approach (the "IRB") for purposes of the advanced approaches rule. During the parallel run evaluation process, the agencies observed several areas where the qualification requirements for applying the advanced approaches rule would benefit from additional clarification. Specifically, the proposed rule would modify sections 122 and 131 of the advanced approaches rule to ensure that advanced approaches banking organizations appropriately: (i) consider all relevant and material information to estimate probability of default ("PD"), loss given default ("LGD"), and exposure at default ("EAD"); (ii) quantify risk parameters for wholesale and retail exposures; and (iii)

⁹ 72 FR 69288 (December 7, 2007).

¹⁰ 12 CFR 324.22(b)(1)(iii).

establish internal requirements for collateral and risk management processes. The proposed modifications are consistent with the processes already in place, and the FDIC staff does not expect material procedural changes to the advanced approaches rule to result from these technical revisions.

Under the advanced approaches rule, an advanced approaches banking organization that has received supervisory approval to calculate EAD for derivative contracts using the internal models methodology (IMM) is permitted to reduce effective expected positive exposure by the credit valuation adjustment recognized on the advanced approaches banking organization's balance sheet to reflect the fair value adjustment for counterparty credit risk in the valuation of a group of over-the-counter (OTC) derivative transactions in a netting set. Similarly, the proposed rule would allow advanced approaches banking organizations to reduce the EAD for OTC derivative contracts calculated according to the current exposure methodology in section 132(c) for the purpose of calculating advanced approaches total risk-weighted assets.

The proposed rule also would remove the adjustment to the margin period of risk in the IMM for large netting sets of cleared transactions. Agency staffs no longer believe that the aggregate size of the netting set as a single criterion constitutes a sufficient reason to adjust the margin period of risk upward for cleared transactions. The agencies are therefore proposing to amend this provision to clarify that cleared transactions are exempt from the twenty-business day, margin period of risk requirement if they would only meet that requirement because the cleared transactions are part of a netting set subject to a collateral agreement that exceeds 5,000 trades at any time during the previous quarter. However, for any netting set that involves illiquid collateral or OTC derivatives that cannot easily be replaced, or that has two margin disputes within a netting set over the previous two quarters that last for a certain length of time, the

margin period of risk would require adjustments regardless of whether the netting set consists of cleared transactions.

The proposed rule also would clarify that the calculation and disclosure of the supplementary leverage ratio would apply to any banking organization, regardless of the status of its parallel run process, that triggers one of the threshold criteria for applying the advanced approaches rule as described in section 100(b)(1). Accordingly, regardless of an advanced approaches banking organization's parallel run status, an advanced approaches banking organization would calculate and disclose its supplementary leverage ratio and the components thereof (that is, tier 1 capital and total leverage exposure) each quarter, beginning in the first quarter in 2015.

In addition, the proposed rule would permit clearing member banking organizations to assign a 0 percent risk weight under subpart E to the trade exposure amount of a cleared transaction that arises when a clearing member banking organization does not guarantee the performance of the central counterparty (CCP) and has no payment obligation to the clearing member client in the event of a CCP default. Under the 2013 capital rule, the trade exposure amount of such a transaction would be assigned a 2 percent risk weight if it was with a qualifying CCP and a risk weight according to section 32 if it was with a CCP that is not a qualifying CCP. This proposed approach would align the risk-based capital requirements for client-cleared transactions with recently finalized revisions to the treatment of those transactions under the supplementary leverage ratio final rule and to the Basel Committee's Capital requirements for bank exposures to central counterparties.

Finally, the proposed rule would make certain technical corrections to the advanced approaches rule in the 2013 capital rule. For example, the proposed rule would correct internal

cross-references in subpart E of the 2013 capital rule that impact advanced approaches banking organizations.

Conclusion

FDIC staff recommends that the FDIC Board adopt the attached interagency NPR and authorize its publication in the *Federal Register* for a 60-day comment period.

Staff Contacts:

RMS

Bobby Bean ext. 8-6705
Ryan Billingsley ext. 8-3797
Benedetto Bosco ext. 8-6853

Legal

Michael Phillips ext. 8-3581
Rachel Ackmann ext. 8-6858
Grace Pyun ext. 8-3609