

June 16, 2015

MEMORANDUM TO: Board of Directors

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



SUBJECT: Regulatory Capital Rules: Regulatory Capital, Revisions
Applicable to Banking Organizations Subject 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 regulatory capital rules applicable to banking organizations (the “2013 capital rule”). In December 2014, the agencies issued a notice of proposed rulemaking (“NPR”) for public comment in the *Federal Register* to clarify and amend certain aspects of the 2013 capital rule that are applicable only to banking organizations subject to the advanced approaches framework in the 2013 capital rule. Staff now is seeking the approval of the FDIC Board of Directors (“FDIC Board”) to publish the attached interagency final rule, which is substantively identical to the NPR. Staff expects that the OCC and FRB also will approve the publication of this interagency final rule.

Recommendation: That the FDIC Board approve the attached interagency final rule and authorize its publication in the *Federal Register*.

Concur:



Charles Yi
General Counsel

Discussion:

Background

The agencies 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 advanced approaches rule. If the primary Federal supervisor determines that the banking

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 part 324, subpart E.

³ 12 CFR 324.100(b)(1).

⁴ 12 U.S.C. 5371.

⁵ 12 CFR 324.121(c).

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 and in March 2015, 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.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.

In December 2014, the agencies issued a proposed rule for public comment in the *Federal Register* to make such clarifications and amendments.⁸ The agencies received two comments, one from a trade associations and one from a public interest advocacy group. The agencies are finalizing the proposed rule, and the FDIC is clarifying its prior *Federal Register* instructions regarding its prompt corrective action ("PCA") rules in conjunction with the regulatory capital framework. The final rule, discussed below, is 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.

Final Rule

The final rule makes various clarifications and revisions to the advanced approaches rule in conjunction with the 2013 capital rule. Included among these clarifications, the final rule amends the definition of residential mortgage exposure. The 2013 capital rule inadvertently

⁶ 12 CFR 324.121(d).

⁷ FRB Press Release <http://www.federalreserve.gov/newsevents/press/bcreg/20140221a.htm>, <http://www.federalreserve.gov/newsevents/press/bcreg/20150331a.htm>.

⁸ 79 FR 75455 (Dec. 18, 2014).

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.⁹ The final rule states that such an exposure must be managed as part of a 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 also makes the definition consistent with the definition used in the 2007 advanced capital adequacy framework implementing Basel II¹⁰ (“2007 rule”).

The final rule clarifies 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.¹¹ 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 final rule clarifies 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 final rule clarifies sections 122 and 131 of the 2013 capital rule, which set forth the qualification requirements and general credit risk methodology for the internal ratings-based approach (“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,

⁹ 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.

¹⁰ 72 FR 69288 (December 7, 2007).

¹¹ 12 CFR 324.22(b)(1)(iii).

the final rule modifies 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 credit exposures; and (iii) establish internal requirements for collateral and risk management processes. The 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 (“CVA”) recognized on the advanced approaches banking organization’s balance sheet, to reflect the fair value adjustment for counterparty credit risk in the valuation of over-the-counter (“OTC”) derivative transactions in a netting set. Similarly, the final rule allows 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 final rule also removes 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 amending 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 final rule also clarifies that the calculation and disclosure of the supplementary leverage ratio applies 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, such banking organization must 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 final rule clarifies that the insured depository institution, in addition to the consolidated top-tier holding company, must disclose its supplementary leverage ratio and the components thereof.

In addition, the final rule permits clearing member banking organizations to assign a 0 percent risk weight under the advanced approaches rule 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 of the 2013 capital rule if it was with a CCP that is not a qualifying CCP. The final rule aligns the risk-based capital requirements for

client-cleared transactions with the treatment of those transactions under the supplementary leverage ratio final rule.

The final rule also makes certain technical corrections to the advanced approaches rule in the 2013 capital rule. For example, the final rule corrects internal cross-references in the advanced approaches rule. Finally, the final rule is clarifying the FDIC's PCA rules in 12 CFR 324.403(b). The FDIC has provided this clarification to ensure that its PCA rules, as published in the *Federal Register*, are identical to the current PCA rules of the FRB and the OCC.

Conclusion

FDIC staff recommends that the FDIC Board adopt the attached interagency final rule and authorize its publication in the *Federal Register*.

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