

October 1, 2018

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director

SUBJECT: Regulatory Capital Rule: Standardized Approach for Calculating the Exposure Amount of Derivative Contracts

Summary: Staff is seeking the approval of the Federal Deposit Insurance Corporation (“FDIC”) Board of Directors (“FDIC Board”) to publish the attached interagency notice of proposed rulemaking (“proposed rule,” “proposal,” or “NPR”) to implement a new approach, titled the standardized approach for counterparty credit risk (“SA-CCR”), for calculating the exposure amount of derivative contracts under the regulatory capital rule (“capital rule”) of the FDIC, the Board of Governors of the Federal Reserve System (“FRB”), and the Office of the Comptroller of the Currency (“OCC”) (collectively, the “agencies”). The proposal would replace the current exposure methodology (“CEM”) as an alternative method for purposes of calculating advanced approaches total risk-weighted assets under the capital rule. An advanced approaches banking organization would be required to use SA-CCR to calculate its standardized total risk-weighted assets; a non-advanced approaches banking organization could elect to use either CEM or SA-CCR for purposes of calculating its standardized total risk-weighted assets.

The proposal would update other parts of the capital rule to account for the proposed implementation of SA-CCR by: (1) requiring an advanced approaches banking organization to use SA-CCR to determine the exposure amount of derivative contracts for purposes of total

Concur:

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leverage exposure (the denominator of the supplementary leverage ratio); (2) incorporating SA-CCR into the cleared transaction framework under the capital rule; and (3) making other technical amendments with respect to cleared transactions.

There is only one FDIC-supervised institution that would be required under this proposed rule to apply SA-CCR.

Recommendation: Staff recommends that the FDIC Board approve the NPR and authorize its publication in the *Federal Register* with a 60-day public comment period.

Discussion:

I. Background and Application of the Proposed Rule

This NPR would adopt SA-CCR as a new methodology for calculating the exposure amount of derivative contracts under the capital rule that would provide important improvements to risk-sensitivity and calibration relative to CEM, resulting in more appropriate capital requirements for derivative contracts. The proposed SA-CCR capital treatment for derivative contracts is more risk-sensitive than the CEM and less complex and model-dependent than the internal models methodology (“IMM”) that could be used by advanced approaches banking organizations, subject to the regulatory approval. The proposed rule is substantially compatible with international standards issued by the Basel Committee on Banking Supervision (“BCBS”) regarding regulatory capital treatment for derivative contracts among internationally active banking organizations.

The proposal would require an advanced approaches banking organization to use SA-CCR to determine the exposure amount for a derivative contract for purposes of calculating its standardized total risk-weighted assets and total leverage exposure in the supplementary leverage

ratio. The proposed rule would require an advanced approaches banking organization to implement SA-CCR by July 1, 2020.

The proposal also would revise the advanced approaches in the capital rule by replacing CEM with SA-CCR. Therefore, an advanced approaches banking organization would have the option to use SA-CCR or IMM to determine the exposure amount for a derivative contract. However, if an advanced approaches banking organization elects to use SA-CCR to determine the exposure amount for its non-cleared derivative contracts, it also would be required to use SA-CCR to determine the trade exposure amount for a cleared derivative contract. Requiring an advanced approaches banking organization to use either SA-CCR or IMM for all purposes under the advanced approaches would promote consistency within the capital rule and is operationally less complex than an approach that provides for optionality within the capital rule for both non-cleared and cleared derivative transactions. This feature of the proposal also facilitates regulatory reporting and the supervisory assessment of a banking organization's capital management program.

Under the proposal, for non-advanced approaches banking organizations, SA-CCR would be available as an option to CEM, because the implementation of SA-CCR would require internal systems enhancements and other operational modifications that could be costly and present additional burden. A non-advanced approaches banking organization that elects to use SA-CCR would also be required to use SA-CCR to determine the trade exposure amount for its cleared derivative contracts and for purposes of calculating the risk-weighted asset amount of the default fund contribution of a central counterparty ("CCP") or qualifying central counterparty ("QCCP").

II. Mechanics of SA-CCR

A. Netting Sets

Under SA-CCR, a banking organization would calculate the exposure amount of its derivative contracts at the netting set level, meaning either one derivative contract between a banking organization and a single counterparty, or a group of derivative contracts between a banking organization and a single counterparty that are subject to a qualifying master netting agreement.

B. Hedging Sets

For purposes of the potential future exposure (“PFE”) calculation under SA-CCR, a banking organization would fully or partially net within each hedging set, which are derivative contracts within the same netting set that share similar risk factors. The formula for arriving at PFE under SA-CCR of netted derivative contracts within a hedging set would be particular to each hedging set type and would reflect different regulatory correlation assumptions between risk factors in the hedging sets.

C. Exposure Amount

Under SA-CCR, the exposure amount for a derivative contract would be equal to an alpha factor of 1.4 multiplied by the sum of the replacement cost of the netting set and PFE of the netting set and is calibrated to produce exposures that are no lower than those amounts calculated using the IMM.

D. Replacement Cost

Replacement cost generally is the cost of replacing a given contract if the banking organization’s counterparty defaults. SA-CCR would provide separate formulas for replacement cost depending on whether the counterparty to a banking organization is required to post

variation margin for a netting set.¹ In general, when a banking organization records a net positive amount of financial collateral, the replacement cost would be reduced. Conversely, when the banking organization records a net negative amount of financial collateral, the replacement cost would increase. A replacement cost calculation of a netting set subject to a variation margin requirement is designed to reflect the maximum possible unsecured exposure that would not trigger a variation margin call.

If the netting set is not subject to a variation margin requirement or the counterparty of the banking organization is not required to post variation margin, the replacement cost is the greater of (1) the sum of the fair values of the derivative contracts within the netting set, less the net independent collateral² amount applicable to the derivative contracts, or (2) zero. If the netting set is subject to a variation margin requirement such that the counterparty of the banking organization must post variation margin, the replacement cost is generally the greater of (1) the sum of the fair values of the derivative contracts within the netting set, less the net independent collateral amount and the variation margin applicable to such derivative contracts; (2) the sum of the variation margin threshold and minimum transfer amount applicable to the derivative contracts within the netting set less the net independent collateral amount applicable to such derivative contracts; or (3) zero.

¹ For purposes of this proposal, variation margin means financial collateral that is subject to a collateral agreement provided by one party to its counterparty to meet the performance of the first party's obligations under one or more transactions between the parties as a result of a change in value of such obligations since the last time such financial collateral was provided.

² Independent collateral (also known as an initial margin) is defined generally as financial collateral, other than variation margin that is subject to a collateral agreement, or upon which the banking organization has a perfected, first-priority security interest or the legal equivalent thereof, the amount of which does not change directly in response to the value of the derivative contract or contracts that the financial collateral secures.

E. Aggregated Amount and Hedging Set Amounts

Under the proposal, the aggregated amount of the PFE for a netting set would result from the product of the PFE multiplier and the sum of all hedging set amounts within the netting set. Hedging sets would be determined by derivative contracts that share similar risk factors based on the following asset classes: interest rate, foreign exchange, credit, equity, and commodities. A banking organization would then determine each hedging set amount using asset-class specific formulas that allow for full or partial netting.

F. PFE Multiplier

SA-CCR would introduce the concept of a PFE multiplier, which would allow a banking organization to reduce the PFE amount through recognition of overcollateralization and negative fair value amounts of the derivative contracts within a netting set. The PFE multiplier would reduce the aggregated amount of PFE of a given derivative netting set by taking into account the amount of excess collateral available and negative fair value of the set. The PFE multiplier would have a value of between 1 and 0.05 depending on the value of the financial collateral held compared to the net fair value of the derivative contract.

G. Adjusted Derivative Contract Amount

Under the proposal, a banking organization would calculate an adjusted derivative contract amount for each derivative contract prior to aggregating these amounts within a hedging set for purposes of calculating default exposure for counterparty credit risk, and therefore risk weighted assets for the capital rule. The adjusted derivative contract amount is intended to reflect a conservative estimate of the effective expected positive exposure³ (“EEPE”) of the

³ The EEPE for a netting set is the time-weighted average of the effective expected exposure profile over a one-year horizon. Effective exposure is defined in the capital rule to mean

derivative contract based on supervisory-provided inputs and the risk horizon of the particular derivative contract, assuming zero market value and zero collateral. Specifically, a banking organization would calculate the adjusted derivative contract amount as the adjusted notional amount of the derivative contract, multiplied by a supervisory factor, maturity factor, and supervisory delta. The adjusted notional amount generally specifies the size of the derivative contract. The supervisory factor would convert the adjusted notional amount of the derivative contract into an EEPE based on the measured volatility specific to each asset class over a one-year horizon. The maturity factor would scale down the one-year time horizon of the supervisory factor to the appropriate risk horizon of the derivative contract. The supervisory delta adjustment would reflect the sensitivity of the derivative contract, scaled to unit size, to the underlying risk factor, including the direction of the derivative contract (positive or negative) with respect to the underlying risk factor.

III. Treatment of Default Fund Contribution to CCP/QCCP

The proposal would simplify the formula used to determine the risk-weighted asset amount for a CCP/QCCP's default fund contribution. This proposal would eliminate the current methods for a banking organization to determine the risk-weighted asset amount for its default fund contributions to a CPP or QCCP and implement a new and simpler method that would be based on the banking organization's *pro-rata* share of the CCP's or QCCP's default fund.

IV. Revisions to Supplementary Leverage Ratio

Under the capital rule, an advanced approaches banking organization must meet a minimum supplementary leverage ratio of three percent. A banking organization's

generally the expected value of the probability distribution of non-negative credit risk exposures to a counterparty at any specified future date before maturity date of the longest term transaction in the netting set.

supplementary leverage ratio is the ratio of its tier 1 capital to its total leverage exposure. Total leverage exposure includes both on-balance sheet assets and certain off-balance sheet exposures, including derivative contracts.

The proposal would require advanced approaches banking organizations to use a modified version of SA-CCR (instead of CEM) to determine the exposure amount for derivative contracts for purposes of calculating total leverage exposure. Under the proposal, for the on-balance sheet amount, an advanced approaches banking organization would include in total leverage exposure 1.4 multiplied by the greater of (1) the sum of the fair value of the derivative contracts within a netting set less the net amount of applicable cash variation margin, or (2) zero. For the off-balance sheet amount, an advanced approaches banking organization would include in total leverage exposure 1.4 multiplied by the PFE of each netting set, except an advanced approaches banking organization would not be permitted to recognize collateral in the PFE multiplier. These adjustments are consistent with the current treatment under the capital rule, which generally limits collateral recognition in leverage capital requirements, and also with the leverage standards developed by the BCBS. While the proposal would limit recognition of collateral in the PFE multiplier, the proposal would recognize the shorter risk horizon applicable to margined derivative contracts. The proposed rule would maintain the current treatment for the recognition of cash variation margin in the supplementary leverage ratio. The implementation of a modified SA-CCR for purposes of the supplementary leverage ratio would generally leave unaffected the leverage capital cost for cleared derivatives.

V. Technical Amendments

The NPR would make certain technical corrections and clarifications to the capital rule to: (1) clarify that cash collateral posted by a clearing member banking organization to a QCCP,

which could be considered a receivable under the accounting framework, would not be risk-weighted as a corporate exposure; (2) revise the definition of financial collateral to allow clearing members to recognize non-cash client collateral posted to a CCP as financial collateral; (3) permit a clearing member that does not guarantee a CCP's performance to the clearing member's client to apply a zero percent risk-weight to the CCP-facing portion of the exposure; (4) remove requirements in the capital rule that collateral posted by a clearing member client banking organization to a clearing member must be bankruptcy-remote from the custodian in order for the client bank to avoid the application of capital requirements for the collateral and clarify that a custodian must be acting in its capacity as a custodian for such capital treatment to apply; and (5) revise the capital rule to add an exception to the ten-day holding period for cleared derivative contracts, and apply a scaling factor to the standard haircuts (discounts) to reflect a five-day holding period.

Conclusion:

Staff recommends that the FDIC Board approve the attached NPR and authorize its publication in the *Federal Register* with a 60-day public comment period.

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