DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 3

[Docket No. 06-xx]

RIN 1557- AC95

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulations H and Y; Docket No. R-1238]

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 325

RIN 3064-AC96

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Part 567

[No. 2006-xx]

RIN 1550-AB98

Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications

AGENCIES: Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Treasury.

ACTION: Joint notice of proposed rulemaking.

SUMMARY: The Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), and Office of Thrift Supervision (OTS) (collectively, the Agencies) are proposing revisions to the existing risk-based capital framework that would enhance its risk sensitivity without unduly increasing regulatory burden. These changes would apply to banks, bank holding companies, and savings associations (banking organizations). A banking organization would be able to elect to adopt these proposed revisions or remain subject to the Agencies' existing risk-based capital rules, unless it uses the Advanced Capital Adequacy Framework proposed in the notice of proposed rulemaking published on September 25, 2006 (Basel II NPR).

In this notice of proposed rulemaking (NPR or Basel IA), the Agencies are proposing to expand the number of risk weight categories, allow the use of external credit ratings to risk weight certain exposures, expand the range of recognized collateral and eligible guarantors, use loan-to-value ratios to risk weight most residential mortgages, increase the credit conversion factor for certain commitments with an original maturity of one year or less, assess a charge for early amortizations in securitizations of revolving exposures, and remove the 50 percent limit on the risk weight for certain derivative transactions. A banking organization would have to apply all the proposed changes if it chose to use these revisions.

Finally, in Section III of this NPR, the Agencies seek further comment on possible alternatives for implementing the "International Convergence of Capital Measurement and

Capital Standards: A Revised Framework" (Basel II) in the United States as proposed in the Basel II NPR.

DATES: Comments on this joint notice of proposed rulemaking must be received by [insert date [90] days after publication in the Federal Register].

ADDRESSES: Comments should be directed to:

OCC: You should include OCC and Docket Number 06-xx in your comment. You may submit comments by any of the following methods:

- **Federal eRulemaking Portal**: http://www.regulations.gov. Follow the instructions for submitting comments.
- **OCC Web Site**: http://www.occ.treas.gov. Click on "Contact the OCC," scroll down and click on "Comments on Proposed Regulations."
- **E-mail address**: regs.comments@occ.treas.gov.
- **Fax**: (202) 874-4448.
- **Mail**: Office of the Comptroller of the Currency, 250 E Street, SW, Mail Stop 1-5, Washington, DC 20219.
- **Hand Delivery/Courier**: 250 E Street, SW, Attn: Public Information Room, Mail Stop 1-5, Washington, DC 20219.

Instructions: All submissions received must include the Agency name (OCC) and docket number or Regulatory Information Number (RIN) for this notice of proposed rulemaking. In general, OCC will enter all comments received into the docket without change, including any business or personal information that you provide. You may review comments and other related materials by any of the following methods:

- **Viewing Comments Personally**: You may personally inspect and photocopy comments at the OCC's Public Information Room, 250 E Street, SW, Washington, DC. You can make an appointment to inspect comments by calling (202) 874-5043.
- **Viewing Comments Electronically**: You may request e-mail or CD-ROM copies of comments that the OCC has received by contacting the OCC's Public Information Room at regs.comments@occ.treas.gov.
- **Docket**: You may also request available background documents and project summaries using the methods described above.

Board: You may submit comments, identified by Docket No. R-1238, by any of the following methods:

- **Agency Web Site:** http://www.federalreserve.gov. Follow the instructions for submitting comments at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.
- **Federal eRulemaking Portal:** http://www.regulations.gov. Follow the instructions for submitting comments.
- **E-mail:** regs.comments@federalreserve.gov. Include docket number in the subject line of the message.
- **FAX:** (202) 452-3819 or (202) 452-3102.
- **Mail:** Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW, Washington, DC 20551.

All public comments are available from the Board's website at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper form in

Room MP-500 of the Board's Martin Building (20th and C Street, NW) between 9:00 a.m. and 5:00 p.m. on weekdays.

FDIC: You may submit by any of the following methods:

- **Federal eRulemaking Portal:** http://www.regulations.gov. Follow the instructions for submitting comments.
- **Agency Web site:** http://www.FDIC.gov/regulations/laws/federal/propose.html
- **Mail:** Robert E. Feldman, Executive Secretary, Attention: Comments/Legal ESS, Federal Deposit Insurance Corporation, 550 17th Street, NW, Washington, DC 20429.
- **Hand Delivered/Courier:** The guard station at the rear of the 550 17th Street Building (located on F Street), on business days between 7:00 a.m. and 5:00 p.m.
- **E-mail:** comments@FDIC.gov.
- **Public Inspection:** Comments may be inspected and photocopied in the FDIC Public Information Center, Room E-1002, 3502 Fairfax Drive, Arlington, VA 22226, between 9:00 a.m. and 5:00 p.m. on business days.

Instructions: Submissions received must include the Agency name and title for this notice. Comments received will be posted without change to http://www.FDIC.gov/regulations/laws/federal/propose.html, including any personal information provided.

OTS: You may submit comments, identified by No. 2006-xx, by any of the following methods:

- **Federal eRulemaking Portal:** http://www.regulations.gov. Follow the instructions for submitting comments.
- **E-mail address:** regs.comments@ots.treas.gov. Please include No. 2006-xx in the subject line of the message and include your name and telephone number in the message.

- **Fax:** (202) 906-6518.
- **Mail:** Regulation Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW, Washington, DC 20552, Attention: No. 2006-xx.
- **Hand Delivery/Courier:** Guard's Desk, East Lobby Entrance, 1700 G Street, NW, from 9:00 a.m. to 4:00 p.m. on business days, Attention: Regulation Comments, Chief Counsel's Office, Attention: No. 2006-xx.

Instructions: All submissions received must include the Agency name and docket number or Regulatory Information Number (RIN) for this rulemaking. All comments received will be posted without change to the OTS Internet Site at http://www.ots.treas.gov/pagehtml.cfm?catNumber=67&an=1, including any personal information provided.

Docket: For access to the docket to read background documents or comments received, go to http://www.ots.treas.gov/pagehtml.cfm?catNumber=67&an=1.

In addition, you may inspect comments at the Public Reading Room, 1700 G Street, NW, by appointment. To make an appointment for access, call (202) 906-5922, send an e-mail to public.info@ots.treas.gov, or send a facsimile transmission to (202) 906-7755. (Prior notice identifying the materials you will be requesting will assist us in serving you.) We schedule appointments on business days between 10:00 a.m. and 4:00 p.m. In most cases, appointments will be available the next business day following the date we receive a request.

FOR FURTHER INFORMATION CONTACT:

OCC: Nancy Hunt, Risk Expert, (202) 874-4923; or Kristin Bogue, Risk Expert, (202) 874-5411, Capital Policy Division; Ron Shimabukuro, Special Counsel, or Carl Kaminski, Attorney, Legislative and Regulatory Activities Division, (202) 874-5090; Office of the Comptroller of the Currency, 250 E Street, SW, Washington, DC 20219.

Board: Thomas R. Boemio, Senior Project Manager, Policy, (202) 452-2982; Barbara Bouchard, Deputy Associate Director, (202) 452-3072; William Tiernay, Supervisory Financial Analyst (202) 872-7579; or Juan C. Climent, Supervisory Financial Analyst, (202) 872-7526 Division of Banking Supervision and Regulation; or Mark E. Van Der Weide, Senior Counsel, (202) 452-2263, Legal Division. For the hearing impaired *only*, Telecommunication Device for the Deaf (TDD), (202) 263-4869.

FDIC: Karl R. Reitz, Capital Markets Specialist, (202) 898-3857, or Bobby R. Bean, Chief, Policy Section Capital Markets Branch, (202) 898-3575, Division of Supervision and Consumer Protection; or Benjamin W. McDonough, Attorney, (202) 898-7411, or Michael B. Phillips, Counsel, (202) 898-3581, Supervision and Legislation Branch, Legal Division, Federal Deposit Insurance Corporation, 550 17th Street, NW, Washington, DC 20429.

OTS: Teresa Scott, Senior Project Manager, Supervision Policy (202) 906-6478; or Karen Osterloh, Special Counsel, Regulation and Legislation Division, Chief Counsel's Office, (202) 906-6639; Office of Thrift Supervision, 1700 G Street, NW, Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

I. Background

In 1989, the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), and Office of Thrift Supervision (OTS) (collectively, the Agencies) implemented a risk-based capital framework for U.S. banking organizations.[1] The Agencies based the framework on the "International Convergence of Capital Measurement and Capital Standards" (Basel I), published by the Basel Committee on Banking Supervision (Basel Committee) in 1988.[2] Basel I addressed certain weaknesses in the various regulatory capital regimes that were in force in most of the world's major banking jurisdictions. In the United States, the Basel I-based framework established a uniform regulatory capital system that captured some of the risks not otherwise captured by the regulatory capital to total assets ratio, provided some modest differentiation of regulatory capital based on broadly defined risk-weight categories, and encouraged banking organizations to strengthen their capital positions.

Consistent with Basel I, the Agencies' existing risk-based capital rules generally assign each credit exposure to one of five broad categories of credit risk, which allows for only limited differentiation in the assessment of credit risk for most exposures. Since the implementation of Basel I-based capital rules, the Agencies have made numerous revisions to these rules in response to changes in financial market practices and accounting standards as well as to implement legislative mandates and address safety and soundness issues. Over time, these revisions have modestly increased the degree of risk sensitivity of the Agencies' risk-based capital rules. The Agencies and the industry generally agree that the existing risk-based capital rules could be modified to better reflect the risks present in many banking organizations' portfolios without imposing undue regulatory burden. In recent years, however, the Agencies

[1] 12 CFR part 3, appendix A (OCC); 12 CFR parts 208 and 225, appendix A (Board); 12 CFR part 325, appendix A (FDIC); and 12 CFR part 567 (OTS). The risk-based capital rules generally do not apply to bank holding companies with less than $500 million in assets. 71 FR 9897 (February 28, 2006).

[2] The Basel Committee on Banking Supervision was established in 1974 by central banks and governmental authorities with bank supervisory responsibilities. Current member countries are Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

have limited modifications to the existing risk-based capital rules while international efforts to create a new risk-based capital framework were in process.

In June 2004, the Basel Committee introduced a new, more risk-sensitive capital adequacy framework, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (Basel II).[3] Basel II is designed to promote improved risk measurement and management processes and better align minimum capital requirements with risk. For credit risk, Basel II includes three approaches for regulatory capital: standardized, foundation internal ratings-based, and advanced internal ratings-based. For operational risk, Basel II also includes three methodologies: basic indicator, standardized, and advanced measurement.

In August 2003, the Agencies issued an advance notice of proposed rulemaking (Basel II ANPR), which explained how the Agencies might implement Basel II in the United States.[4] On September 25, 2006, the Agencies issued a notice of proposed rulemaking that provides the industry with a more definitive proposal for implementing Basel II in the United States (Basel II NPR).[5]

The Basel II NPR identifies two types of U.S. banking organizations that would use the Basel II rules: those for which application of the rules would be mandatory (core banks), and those that might voluntarily apply the rules (opt-in banks) (collectively referred to as Basel II banking organizations). In general, the Basel II NPR defines a core bank as a banking organization that has consolidated total assets of $250 billion or more, has consolidated on-

[3] The complete text for Basel II as amended in November 2005 is available on the Bank for International Settlements Web site at http://www.bis.org/publ/bcbs118.htm.
[4] As stated in its preamble, the Basel II ANPR was based on the consultative document "The New Basel Capital Accord" that was published by the Basel Committee on April 29, 2003. The Basel II ANPR anticipated the issuance of a final revised accord. See 68 FR 45900 (August 4, 2003).
[5] 71 FR 55830 (September 25, 2006).

balance sheet foreign exposure of $10 billion or more, or is a subsidiary of a Basel II banking organization. The Basel II NPR presents the advanced internal ratings-based approach for credit risk and the advanced measurement approach for operational risk. However, the Agencies did seek comment in the Basel II NPR on whether U.S. banking organizations subject to the advanced approaches in the proposed rule (that is, core banks and opt-in banks) should be permitted to use other credit and operational risk approaches provided for in Basel II. The Agencies are seeking further comment on possible alternatives for Basel II banking organizations in Section III of this NPR.

The complexity and cost associated with implementing Basel II in the United States effectively limit its application to those banking organizations that are able to take advantage of economies of scale and absorb the costs associated with the enhanced risk management practices required of Basel II banking organizations. Thus, the implementation of Basel II would create a bifurcated regulatory capital framework in the United States: one set of rules for Basel II banking organizations, and another for banking organizations that do not use the proposed Basel II capital rules (non-Basel II banking organizations).

In comments responding to the Basel II ANPR, Congressional testimony, and other industry communications, several banking organizations, trade associations, and others raised concerns about the competitive effects of a bifurcated regulatory framework on community and regional banking organizations. Among other broad concerns, these commenters asserted that implementing the Basel II capital regime in the United States could result in lower minimum regulatory capital requirements for Basel II banking organizations with respect to certain types of credit exposures. As a result, regulatory capital requirements for similar products could differ depending on the capital regime under which a banking organization operates. Community and regional banking organizations asserted that this would put them at a competitive disadvantage.

To assist in quantifying the potential effects of implementing Basel II in the United States, the Agencies conducted a quantitative impact study during late 2004 and early 2005 (QIS 4).[6] QIS 4 was a comprehensive survey completed on a best efforts basis by 26 of the largest U.S. banking organizations using their own internal estimates of the key risk parameters driving the capital requirements under the Basel II framework. The results of the study suggested that the aggregate minimum risk-based capital requirements for the 26 banking organizations could drop approximately 15.5 percent relative to the existing Basel I-based framework. The QIS 4 results also indicated dispersion in capital requirements across banking organizations and portfolios, which was attributed in part to differences in the underlying data and methodologies used by banking organizations to quantify risk and their overall readiness to implement a Basel II framework. The Basel II NPR contains several provisions designed to limit potential reductions in minimum regulatory capital, such as an extended transition period during which the Agencies can thoroughly review those Basel II systems that are subject to supervisory oversight.

On October 20, 2005, the Agencies issued an advanced notice of proposed rulemaking soliciting public comment on possible revisions to U.S. risk-based capital rules that would apply to non-Basel II banking organizations (Basel IA ANPR).[7] The proposals in this NPR are based on those initial conceptual approaches and take into consideration the public comments that the Agencies received.

Together, the Agencies received 73 public comments from banking, trade, and other organizations and individuals. Generally, most commenters supported the Agencies' goal to

[6] "Summary Findings of the Fourth Quantitative Impact Study," Joint Agency press release, February 24, 2006.
[7] 70 FR 61068 (October 20, 2005).

make the risk-based capital rules more risk-sensitive. Several larger banking organizations and industry groups favored increased risk sensitivity, but argued that many of the proposed revisions should be optional so that banking organizations may weigh the costs and benefits of using the revisions. Several non-Basel II banking organizations and industry groups argued that the U.S. risk-based capital rules should allow banking organizations to use internal assessments of risk to determine their capital requirements. A few commenters endorsed a proposal for a four-tier capital framework that would apply different approaches to banking organizations based on the size and complexity, and the robustness of a banking organization's internal ratings systems. The commenters' proposal included an approach that would permit some non-Basel II banking organizations to use internal rating-based systems.

One commenter suggested tying Basel IA capital requirements directly to the aggregate results for Basel II calculations. This commenter suggested that Basel IA capital charges should link by loan category to the average risk-based capital requirements of the Basel II banking organizations for that loan category, plus a small premium to recognize the substantial costs of implementing Basel II.

Most smaller and midsize banking organizations generally requested that any changes to the existing capital rules be simple and not require large data gathering and monitoring expenses. A number of the smallest banking organizations said that they do not wish to have any changes in the capital rules that apply to them. They noted that they already hold significantly more regulatory capital than the Agencies' risk-based capital rules require and, therefore, amending the rules would have little or no effect.

This NPR makes a number of proposals that should improve the risk sensitivity of the existing risk-based capital rules. The Agencies, however, are not proposing to allow a non-Basel

II banking organization to use internal risk ratings or to use its internal risk measurement processes to calculate risk-based capital requirements for any new categories of exposures.[8] The Agencies believe that the use of these internal ratings and measurement processes should require the systems controls, supervisory oversight, and other qualification requirements that are proposed in the Basel II NPR.

The Agencies also believe that any proposal to tie capital requirements under Basel IA to the capital charges that would result under the proposed Basel II rules is premature. The Agencies anticipate that the Basel II transition phase would not be completed until 2011 at the earliest. The Agencies also have other concerns about the commenter's proposal including the absence of a capital charge for operational risk; the method by which any premium over the Basel II charges would be determined; difficulties in defining comparable portfolios; and the need to periodically update capital requirements, which would significantly increase complexity and burden.

II. Proposed Changes

In considering revisions to the existing risk-based capital rules, the Agencies were guided by five broad principles. A revised framework must: (1) promote safe and sound banking practices and a prudent level of regulatory capital; (2) maintain a balance between risk sensitivity and operational feasibility; (3) avoid undue regulatory burden; (4) create appropriate incentives for banking organizations; and (5) mitigate material distortions in the risk-based capital requirements for large and small banking organizations.

[8] The Agencies' existing capital rules, however, would continue to permit the use of internal ratings for a direct credit substitute (but not a purchased credit-enhancing interest-only strip) assumed in connection with an asset-backed commercial paper program sponsored by a banking organization. 12 CFR part 3, appendix A section 4(g) (OCC); 12 CFR parts 208 and 225, appendix A, section III.B.3.F (Board); 12 CFR part 325, appendix A, section II.B.5.(g)(1) (FDIC); and 12 CFR 567.6(b)(4) (OTS).

The Agencies are concerned about potential competitive disadvantages that could result from capital requirements that differ depending on the capital regime under which a banking organization operates. By allowing non-Basel II banking organizations the choice of adopting all of the provisions in this proposal or continuing to use the existing risk-based capital rules, the proposed regulation is intended to help maintain the competitive position of these banks relative to Basel II banking organizations. Moreover, the proposed rule strives for better alignment of capital and risk, with capital requirements potentially higher for organizations with riskier exposures and lower for those with safer exposures. The Agencies seek to achieve these objectives while balancing operational feasibility and regulatory burden considerations.

In this NPR, the Agencies are proposing to:

- Allow non-Basel II banking organizations the choice of adopting all of the revisions in this proposal or continuing to use the existing risk-based capital rules. The voluntary nature of this proposed rule gives banking organizations the opportunity to weigh the various costs and benefits to them of adopting the new system.
- Increase the number of risk weight categories to which credit exposures may be assigned.
- Use external credit ratings to risk weight certain exposures.
- Expand the range of recognized collateral and eligible guarantors.
- Use loan-to-value ratios to risk weight most residential mortgages.
- Increase the credit conversion factor for various commitments with an original maturity of one year or less.
- Assess a risk-based capital charge for early amortizations in securitizations of revolving exposures.
- Remove the 50 percent limit on the risk weight for certain derivative transactions.

The existing risk-based capital requirements focus primarily on credit risk and do not impose explicit capital charges for interest rate, operational, or other risks. These risks, however, are implicitly covered by the existing risk-based capital rules. The risk-based capital charges proposed in this NPR continue the implicit coverage of risks other than credit risk. Moreover, the Agencies are not proposing revisions to the existing leverage ratio requirement (that is, the ratio of Tier 1 capital to total assets).[9]

To ensure safety and soundness, the Agencies intend to closely monitor the level of risk-based capital at those banking organizations that choose to opt in to Basel IA. Any significant decline in the aggregate level of risk-based capital for these banking organizations may warrant modifications to the proposed risk-based capital rules.

<u>Question 1: The Agencies welcome comments on all aspects of these proposals, especially suggestions for reducing the burden that may be associated with these proposals. The Agencies believe that a banking organization that chooses to adopt these proposals will generally be able to do so with data it currently uses as part of its credit approval and portfolio management processes. Commenters are particularly requested to address whether any of the proposed changes would require data that are not currently available as part of the organization's existing credit approval and portfolio management systems.</u>

A. <u>Opt-In Proposal</u>

In the Basel IA ANPR, the Agencies recognized that certain banking organizations might not want to assume the additional burden that might accompany a more risk-sensitive approach and might prefer to continue to apply the existing risk-based capital rules. Additionally, many commenters, particularly community bank respondents, favored an approach that would allow

[9] 12 CFR 3.6(b) and (c) (OCC); 12 CFR part 208, appendix B and 12 CFR part 225, appendix D (Board); 12 CFR part 325.3 (FDIC); and 12 CFR 567.8 (OTS).

well-capitalized banking organizations to remain under the existing risk-based capital rules. For these commenters, limiting regulatory burden was a higher priority than increasing the risk sensitivity of their risk-based capital charges. One group of midsize banking organizations recommended applying the proposed rules only to banking organizations with assets of $500 million or greater. Some commenters noted the risk of “cherry picking” in permitting a choice between the framework discussed in the Basel IA ANPR and the existing risk-based capital rules, or adoption of parts of each.

The Agencies are proposing that a non-Basel II banking organization may, if it chooses, adopt the revisions in this proposed rule. If a banking organization chooses to use these proposed capital rules, however, it would be required to implement them in their entirety. The Agencies are proposing to permit a banking organization to adopt these proposals by notifying its primary Federal supervisor. Before a banking organization decides to opt in to these proposals, the Agencies expect that the organization would review its ability to collect and utilize the information required and evaluate the potential impact on its regulatory capital. A banking organization that chooses to adopt these proposals (that is, opts in) would also be able to request returning to the existing capital rules by first notifying its primary Federal supervisor. In its review of such a request, the primary Federal supervisor would ensure that the risk-based capital requirements appropriately reflect the risk profile of the banking organization and the change is not for purposes of capital arbitrage. Further, the Agencies expect that a banking organization would not alternate between the existing and proposed risk-based capital rules. The Agencies would reserve the authority to require a banking organization to calculate its minimum risk-based capital requirements in accordance with this proposal or the existing risk-based capital rules.

Under this proposal, a non-Basel II banking organization could continue to calculate its risk-based capital requirements using the existing risk-based capital rules. In this case, the banking organization would not need to notify its primary Federal supervisor or take any other action. As noted, above, however, the Agencies would retain the authority to require a non-Basel II banking organization to use either the existing or the proposed risk-based capital rules if the banking organization's primary Federal supervisor determines that a particular capital rule is more appropriate for the risk profile of the banking organization.

<u>Question 2: The Agencies seek comment on all aspects of the proposal to allow banks to opt in to and out of the proposed rules. Specifically, the Agencies seek comment on any operational challenges presented by the proposed rules. How far in advance should a banking organization be required to notify its primary Federal supervisor that it intends to implement the proposed rule? If a banking organization wishes to "opt out" of the proposed rule, what criteria should guide the review of a request to opt out? When should a banking organization's election to opt in or opt out be effective? In addition, the Agencies seek comment on the appropriateness of requiring a banking organization to apply the proposed Basel IA capital rules based on a banking organization's asset size, level of complexity, risk profile, or scope of operations.</u>

B. <u>Increase the Number of Risk Weight Categories</u>

The Agencies' existing risk-based capital rules contain five risk-weight categories: zero, 20, 50, 100, and 200 percent. Differentiation of credit quality among individual exposures is generally limited to these few risk-weight categories. In the Basel IA ANPR, the Agencies suggested adding four new risk-weight categories (35, 75, 150, and 350 percent) and invited comment on whether: (1) increasing the number of risk-weight categories would allow supervisors to more closely align capital requirements with risk; (2) the suggested additional risk-weight categories would be appropriate; (3) the risk-based capital framework should include more risk-weight categories than the four suggested; and (4) increasing the number of risk-weight categories would impose unnecessary burden on banking organizations.

Commenters generally supported increasing the number of risk-weight categories to enhance the overall risk-sensitivity of the risk-based capital rules. However, many commenters noted that adding too many categories could make the rules too complex. Several commenters argued that the 350 percent risk weight is too high and suggested that any new risk-weight categories should be lower than 100 percent to reflect the lower risks associated with certain mortgages and other high-quality assets. A few commenters suggested that the Agencies create a new 10 percent risk weight category to account for very low-risk assets.

The Agencies agree with the commenters that increasing the number of risk-weight categories would allow for greater risk sensitivity than the existing risk-based capital rules. Accordingly, the Agencies propose to add 35, 75, and 150 percent risk-weight categories. The Agencies believe that adding a 150 percent risk weight category and expanding the use of the existing 200 percent risk weight category would allow for somewhat greater differentiation of credit risk among more risky exposures than is permitted by the existing capital rules. At the same time, for certain types of relatively low-risk exposures, the existing risk-based capital charge may be higher than warranted. Therefore, the 35 and 75 percent risk weight categories provide an opportunity to increase the risk sensitivity of the regulatory capital charges for these exposures.

The Agencies agree that the credit risks covered by this NPR generally do not warrant a 350 percent category, and are not proposing to add this risk weight. <u>Question 3: The Agencies seek comment on whether these or any other new risk weight categories would be appropriate.</u>

More specifically, the Agencies are interested in any comments regarding whether any categories of assets might warrant a risk weight higher than 200 percent and what risk weight might be appropriate for such assets. The Agencies also solicit comment on whether a 10 percent risk weight category would be appropriate and what exposures should be included in this risk weight category.

C. Use of External Credit Ratings to Risk Weight Exposures

The Agencies' existing risk-based capital rules permit the use of external credit ratings issued by a nationally recognized statistical rating organization (NRSRO) [10] to assign risk weights to recourse obligations, direct credit substitutes (DCS), residual interests (other than a credit-enhancing interest-only strip), and asset- and mortgage-backed securities.[11] For example, AAA- and AA-rated mortgage-backed securities[12] are assigned to the 20 percent risk weight category while BB-rated mortgage-backed securities are assigned to the 200 percent risk weight category. When the Agencies revised the risk-based capital rules to allow for the use of external credit ratings issued by an NRSRO for the types of exposures listed above, the Agencies acknowledged that such ratings could be used to determine the risk-based capital requirements for other types of debt instruments, such as rated corporate debt.

In the Basel IA ANPR, the Agencies suggested expanding the use of NRSRO ratings to determine the risk-based capital charge for most categories of NRSRO-rated exposures,

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[10] An NRSRO is an entity recognized by the Division of Market Regulation of the Securities and Exchange Commission (SEC) as a nationally recognized statistical rating organization for various purposes, including the SEC's uniform net capital requirements for brokers and dealers 17 CFR 240.15c3-1). On September 29, 2006, the President signed the Credit Rating Agency Reform Act of 2006 (Reform Act) (Pub. L. 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 in order to determine whether any modification of the Agencies' definition of an NRSRO is appropriate.

[11] Some synthetic structures may also be subject to the external rating approach. For example, certain credit-linked notes issued from a synthetic securitization are risk weighted according to the rating given to the notes. 66 FR 59614, 59622 (November 29, 2001).

[12] The ratings designations (for example, "AAA," "BBB," "A-1," and "P-1"), are illustrative and do not indicate any preference for, or endorsement of, any particular rating agency description system.

including sovereign and corporate debt securities and rated loans. The Agencies indicated, however, that they were considering retaining the existing risk-based capital treatment for U.S. government and agency exposures, U.S. government-sponsored entity exposures, and municipal obligations. Tables 1 and 2 in the Basel IA ANPR matched ratings and possible corresponding risk weights for long- and short-term exposures. The Agencies requested comment on the use of other methodologies to assign risk weights to unrated exposures.

Many commenters supported the use of external ratings in principle but noted that non-Basel II banking organizations' holdings of securities and loans generally are not rated. Thus, they suggested that the expansion of the use of NRSRO ratings would have little impact on these banking organizations. A few commenters also asserted that using NRSRO ratings might discourage lending to non-rated entities.

Many commenters argued that the risk weights suggested in the Basel IA ANPR were too high. In particular, many commenters said that the 350 percent and 200 percent risk weights for exposures rated BB+ and lower would be unnecessarily punitive. A few commenters also expressed concerns about NRSRO ratings generally. These commenters said that there are too few NRSROs to ensure adequate market discipline, NRSROs are inadequately supervised, and NRSRO ratings often react too slowly to crises.

A number of commenters suggested alternative methods for differentiating risk among commercial exposures and making the capital requirements for these exposures more risk sensitive. Many larger banking organizations suggested allowing an internal risk measurement approach to determine risk-based capital requirements. Some smaller banking organizations sought increased recognition of a variety of risk mitigation techniques, such as personal guarantees and collateral.

The Agencies acknowledge that expanding the use of external ratings may have little effect on the risk-based capital requirements for existing loan portfolios at most banking organizations. To the extent that assets in a banking organization's investment portfolio are rated, however, the Agencies believe that using external ratings will improve risk sensitivity of the capital charges for these assets. Furthermore, implementing broader use of external ratings would also provide a basis for expanding recognition of eligible guarantees and recognized collateral. Accordingly, the Agencies are proposing to expand the use of external ratings for purposes of determining the risk-based capital charge for certain externally rated exposures as described below in the sections on direct exposures, recognized collateral, and eligible guarantees.

An external rating would be defined as a credit rating that is assigned by an NRSRO, provided that the credit rating (1) fully reflects the entire amount of credit risk with regard to all payments owed to the holder and the credit risk associated with timely repayment of principal and interest; (2) is published in an accessible public form, for example, on the NRSRO's web site and in financial media; (3) is monitored by the NRSRO; and (4) is, or will be, included in the issuing NRSRO's publicly available transition matrix.[13] If an exposure has two or more external ratings, the banking organization must use the lowest assigned external rating to risk weight the exposure. If an exposure has components that are assigned different external ratings, a banking organization would be required to assign the lowest rating to the entire exposure. If a component is not externally rated, the entire exposure would be treated as unrated.

i. Direct Exposures

[13] A transition matrix tracks the performance and stability (or ratings migration) of an NRSRO's issued external ratings.

The Agencies are proposing to use external ratings to risk weight (1) sovereign[14] debt and debt securities, and (2) debt securities issued by and rated loans to non-sovereign entities including securities firms, insurance companies, bank holding companies, savings and loan holding companies, multilateral lending and regional development institutions, partnerships, limited liability companies, business trusts, special purpose entities, associations and other similar organizations. External ratings for direct exposures to sovereigns would be based on the external rating of the exposure or, if the exposure is unrated, on the sovereign's issuer rating. Direct exposures to non-sovereigns would be risk weighted based on the external rating of the exposure. For example, a banking organization would assign any AAA-rated debt security issued by a corporation, insurance company, or securities firm to the 20 percent risk weight category. The Agencies are, however, not proposing to permit the use of issuer ratings for non-sovereigns.

The risk weights for direct exposures are detailed in Table 1 (long-term exposures) and Table 2 (short-term exposures) below. The Agencies are also proposing to replace the existing risk-weight tables for externally rated recourse obligations, DCS, residual interests (other than a credit-enhancing interest-only strip), and asset- and mortgage-backed securities[15] with the risk weights in Tables 1 and 2.[16] This proposed treatment would apply to all externally rated

[14] A sovereign is defined as a central government, including its agencies, departments, ministries, and the central bank. A sovereign does not include state, provincial, or local governments, or commercial enterprises owned by a central government.
[15] 12 CFR part 3, appendix A, section 4, Tables B and C (OCC); 12 CFR parts 208 and 225, appendix A, section III.B.3.c.i. (Board); 12 CFR part 325, appendix A, section II.B.5.(d) (FDIC); and 12 CFR 567.6(b) (OTS) (the Recourse Rule).
[16] With the exception of the clarification of the definition of an external rating and the proposed risk-based capital charge for securitizations with early amortization features described in section F of this NPR, the Agencies are not proposing to make other changes to the existing risk-based capital rules for recourse obligations, DCS, and residual interests. See 12 CFR part 3, appendix A, section 4 (OCC); 12 CFR parts 208 and 225, appendix A, section III.B.3 (Board); 12 CFR part 325, appendix A, section II.B.5 (FDIC); and 12 CFR 567.6(b) (OTS) (Recourse Rule).

exposures unless the banking organization uses a market risk rule.[17] For a banking organization that uses a market risk rule, this treatment applies only to externally rated exposures held in the banking book.

The Agencies intend to retain the existing risk-based capital treatment for direct exposures to public-sector entities,[18] the U.S. government and its agencies, U.S. government-sponsored agencies, and depository institutions (U.S. and foreign) and for unrated loans made to non-sovereign entities. Exposures issued by these entities are not subject to Table 1 or 2.

Table 1: Proposed Risk Weights Based on External Ratings for Long-Term Exposures

Long-term rating category	**Example**	**Sovereign Risk Weight** (in percent)	**Non-Sovereign Risk Weight** (in percent)	**Securitization Exposure[1] Risk Weight** (in percent)
Highest investment grade rating	AAA	0	20	20
Second-highest investment grade rating	AA	20	20	20
Third-highest investment grade rating	A	20	35	35
Lowest-investment grade rating-plus	BBB+	35	50	50
Lowest-investment grade rating	BBB	50	75	75
Lowest-investment grade rating-minus	BBB-	75	100	100
One category below investment grade	BB+, BB	75	150	200
One category below investment grade-minus	BB-	100	200	200
Two or more categories below investment grade	B, CCC	150	200	[1]

[17] See 12 CFR part 3, appendix B (OCC); 12 CFR parts 208 and 225, appendix E (Board); and 12 CFR part 325 appendix C (FDIC). The Agencies issued an NPR that proposes revisions to the Market Risk rules. OTS does not currently have a market risk rule, but has proposed to add a new rule on this topic in the Market Risk NPR. See 71 FR 55958 (September 25, 2006).

[18] Public-sector entities include states, local authorities and governmental subdivisions below the central government level in an Organization for Economic Cooperation and Development (OECD) country. In the United States, this definition encompasses a state, county, city, town, or other municipal corporation, a public authority, and generally any publicly-owned entity that is an instrument of a state or municipal corporation. This definition does not include commercial companies owned by the public sector. The OECD-based group of countries comprises all full members of the OECD, as well as countries that have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the Fund's General Arrangements to Borrow.

Unrated[2]	n/a	200	200	[1]

Table 2: Proposed Risk Weights Based on External Ratings for Short-Term Exposures

Short-term rating category	**Example**	**Sovereign Risk Weight** (in percent)	**Non-Sovereign Risk Weight** (in percent)	**Securitization Exposure[1] Risk Weight** (in percent)
Highest investment grade rating	A-1, P-1	0	20	20
Second-highest investment grade rating	A-2, P-2	20	35	35
Lowest investment grade rating	A-3, P-3	50	75	75
Unrated[2]	n/a	100	100	[1]

[1] A securitization exposure includes asset- and mortgage-backed securities, recourse obligations, DCS, and residuals (other than a credit-enhancing interest-only strip). For long-term securitization exposures that are externally rated more than one category below investment grade, short-term exposures that are rated below investment grade, or any unrated securitization exposures, the existing risk-based capital treatment as described in the Agencies' Recourse Rule would be used

[2] Unrated sovereign exposures and unrated debt securities issued by non-sovereigns would receive the risk weight indicated in Tables 1 and 2. Other unrated exposures, for example, unrated loans to non-sovereigns, would continue to be risk weighted under the existing risk-based capital rules.

The proposed risk weights in Tables 1 and 2 are generally consistent with the historical default rates reported in the default studies published by NRSROs. The Agencies believe that the additional application of external ratings to the exposures specified above would improve the risk sensitivity of the capital treatment for those exposures. Furthermore, the Agencies believe that the revised risk-weight tables for externally rated recourse obligations, DCS, residual interests (other than credit-enhancing interest only-strips), and asset- and mortgage-backed securities would also better reflect risk than the Agencies' existing risk-based capital rules.

Under the proposal, the Agencies would retain their authority to reassign an exposure to a different risk weight on a case-by-case basis to address the risk of a particular exposure.

ii. Recognized Financial Collateral

The Agencies' existing risk-based capital rules recognize limited types of collateral: (1) cash on deposit; (2) securities issued or guaranteed by central governments of the OECD countries; (3) securities issued or guaranteed by the U.S. government or its agencies; (4) securities issued or guaranteed by U.S. government-sponsored agencies; and (5) securities issued by certain multilateral lending institutions or regional development banks.[19] In the past, the banking industry has commented that the Agencies should recognize a wider array of collateral types for purposes of reducing risk-based capital requirements.

In the Basel IA ANPR, the Agencies noted that they were considering expanding the list of recognized collateral to include short- or long-term debt securities (for example, corporate and asset- and mortgage-backed securities) that are externally rated at least investment grade by an NRSRO, or issued or guaranteed by a sovereign central government that is externally rated at least investment grade by an NRSRO. Consistent with the proposed treatment for direct exposures, the Basel IA ANPR suggested assigning exposures or portions of exposures collateralized by financial collateral to risk-weight categories based on the external rating of that collateral. To use this expanded list of collateral, the Basel IA ANPR considered requiring a banking organization to have collateral management systems to track collateral and readily determine its realizable value. The Agencies sought comment on whether this approach for expanding the scope of recognized collateral would improve risk sensitivity without being overly burdensome.

Many commenters supported expanding the list of recognized collateral, but several also noted that using NRSRO ratings would have little effect on most community banks. Some commenters suggested reducing the risk weights applied to exposures secured by any collateral

[19] The Agencies' rules for collateral transactions, however, differ somewhat as described in the Agencies' joint report to Congress. "Joint Report: Differences in Accounting and Capital Standards among the Federal Banking Agencies," 70 FR 15379 (March 25, 2005).

that is legally perfected and has objective methods of valuation or can be readily marked-to-market. Many commenters also stated that any collateral valuation and monitoring requirements likely would be too costly to benefit smaller community banks.

To increase the risk sensitivity of the existing risk-based capital rules, the Agencies are proposing to revise the list of recognized collateral to include a broader array of externally rated, liquid, and readily marketable financial instruments. The revised list would incorporate long- and short-term debt securities and securitization exposures that are:

a. Issued or guaranteed by a sovereign where such securities are externally rated at least investment grade by an NRSRO; or an exposure issued or guaranteed by a sovereign with an issuer rating that is at least investment grade; or

b. Issued by non-sovereigns where such securities are externally rated at least investment grade by an NRSRO.

Consistent with the Agencies' existing risk-based capital rules, the Agencies propose to continue to recognize collateral that is either issued or guaranteed by certain sovereigns. For non-sovereign exposures, however, the Agencies propose that the collateral itself must be externally rated investment grade or better to qualify as recognized collateral. The Agencies believe that this more conservative approach for recognizing non-sovereign collateral is appropriate and expect that any guarantee provided by a non-sovereign would be reflected in the external rating of the collateral.

A banking organization would assign exposures collateralized by financial collateral externally rated at least investment grade to the appropriate risk weight in Table 1 or 2 above. If an exposure is partially collateralized, a banking organization could assign the portions of exposures collateralized by the market value of the externally rated collateral to the appropriate risk weight category in Tables 1 and 2 of this NPR. For example, the portion of an exposure collateralized by the market value of a AAA-rated corporate debt security would be assigned to the 20 percent risk weight category. The Agencies are proposing a minimum risk weight of 20 percent for collateralized exposures except as noted below.

The Agencies have decided to retain their respective risk-based capital rules that govern the following collateral: cash, securities issued or guaranteed by the U.S. government or its agencies, and securities issued or guaranteed by U.S. government-sponsored agencies. The Agencies are also retaining the existing risk-based capital rules for exposures collateralized by securities issued or guaranteed by other OECD central governments that meet certain criteria.[20]

iii. Eligible Guarantors

Under the Agencies' existing risk-based capital rules, the recognition of third party guarantees is limited to guarantees provided by central governments of OECD countries, U.S. government and government-sponsored entities, public-sector entities in OECD countries, multilateral lending institutions and regional development banks, depository institutions and qualifying securities firms in OECD countries, depository institutions in non-OECD countries (short-term claims), and central governments of non-OECD countries (local currency exposures only).

In the Basel IA ANPR, the Agencies suggested expanding the scope of eligible guarantors to include any entity whose long-term senior debt has been assigned an external credit rating of at least investment grade by an NRSRO. The applicable risk weight for guaranteed exposures would be based on the risk weights corresponding to the rating of the long-term debt of the guarantor.

[20] 12 CFR part 3, appendix A, section 3(a)(1)(viii) (OCC);and 12 CFR parts 208 and 225, appendix A, section III.C.1 (Board).

Most commenters supported, in principle, expanding the list of eligible guarantors. However, many commenters noted that very few community and midsize banking organizations have exposures that are guaranteed by externally rated entities. Thus, many commenters suggested that this provision would have little impact unless the proposed revisions recognized more types of guarantees.

The Agencies believe that the range of eligible third-party guarantors under the existing risk-based capital rules is restrictive and ignores market practice. As a result, the Agencies are proposing to expand the list of eligible guarantors by recognizing entities that have long-term senior debt (without credit enhancement) rated at least investment grade by an NRSRO or, in the case of a sovereign, an issuer rating that is at least investment grade. Under this NPR, a recognized third-party guarantee would have to:

(1) Be written and unconditional, and, for a sovereign guarantee, be backed by the full faith and credit of the sovereign;

(2) Cover all or a pro rata portion of contractual payments of the obligor on the reference exposure;[21]

(3) Give the beneficiary a direct claim against the protection provider;

(4) Be non-cancelable by the protection provider for reasons other than the breach of the contract by the beneficiary;

(5) Be legally enforceable against the protection provider in a jurisdiction where the protection provider has sufficient assets against which a judgment may be attached and enforced; and

[21] If an exposure is partially guaranteed, the pro rata portion not covered by the guarantee would be assigned to the risk weight category appropriate to the obligor, after consideration of collateral and external ratings.

(6) Require the protection provider to make payment to the beneficiary on the occurrence of a default (as defined in the guarantee) of the obligor on the reference exposure without first requiring the beneficiary to demand payment from the obligor.

To be considered an eligible guarantor, a sovereign or its senior long-term debt (without credit enhancement) must be externally rated at least investment grade. Non-sovereigns must have long-term senior debt (without credit enhancement) that is externally rated at least investment grade. Under this proposal, a banking organization could assign the portions of exposures guaranteed by eligible guarantors to the proposed risk weight category corresponding to the external rating of the eligible guarantors' long-term senior debt in accordance with Table 1 above.

The Agencies would retain the existing risk-weight treatment of exposures guaranteed by the U.S. government and its agencies, U.S. government-sponsored agencies, public-sector entities, depository institutions in OECD countries, and depository institutions in non-OECD countries (short-term exposures only).

<u>Question 4: The Agencies solicit comment on all aspects of the proposed use of external ratings including the appropriateness of the risk weights, expanded collateral, and additional eligible guarantors. The Agencies also seek comment on whether to exclude certain externally rated exposures from the ratings treatment as proposed or to use external ratings as a measure for all externally rated exposures, collateral, and guarantees. Alternatively, should the Agencies retain the existing risk-based capital treatment for certain types of exposures, for example, qualifying securities firms? The Agencies are also interested in comments on all aspects of the scope of the terms sovereign, non-sovereign, and securitization exposures. Specifically, the</u>

Agencies seek comment on the scope of these terms, whether they should be expanded to cover other entities, or whether any entities included in these definitions should be excluded.

iv. Government-Sponsored Agencies

One area of particular interest to the Agencies is the risk weighting of exposures to U.S. government-sponsored agencies, also commonly referred to as government-sponsored entities (GSEs). The Agencies' existing risk-based capital regulations assign a 20 percent risk weight to exposures issued or guaranteed by GSEs. The Basel IA NPR proposes to retain this risk-based capital treatment. The Agencies are aware that there are various types of ratings that might increase the risk sensitivity of risk weights assigned to GSE exposures. For example, NRSROs rate the creditworthiness of short-term senior debt, senior unsecured debt, subordinated debt and preferred stock of some GSEs. These ratings on individual exposures, however, are often based in part on the NRSROs' assessment of the extent to which the U.S. government might come to the financial aid of a GSE if necessary. In this context, and as indicated in the preamble to the Basel II NPR, the Agencies do not believe that risk weight determinations should be based on the possibility of U.S. government financial assistance, except for the financial assistance the U.S. government has legally committed to provide. The Agencies believe the existing approach has thus far met this objective. However, the Agencies also note that as part of the October 19, 2000 agreement with their regulator,[22] both Fannie Mae and Freddie Mac agreed to obtain and disclose annually ratings that would "assess the risk to the government, or the independent financial strength, of each of the companies."[23]

In accordance with the agreement, Fannie Mae and Freddie Mac currently obtain and disclose separate ratings from two NRSROs – Standard & Poor's (S&P) and Moody's Investors

[22] "Freddie Mac and Fannie Mae Enhancements to Capital Strength, Disclosure and Market Discipline", October 19, 2000 (agreement between the GSEs and the Office of Federal Housing Enterprise Oversight).
[23] Ibid, p. 2.

Service (Moody's). The S&P "risk to the government rating" uses the same scale as its standard corporate credit ratings. Currently, Fannie Mae and Freddie Mac both have a risk to the government issuer rating of AA- from S&P, which is unchanged from the initial AA- issuer rating that S&P initially provided in 2001. Moody's "bank financial strength rating" (BFSR) uses a scale of A-E. In 2002, Moody's provided a BFSR of A- to both GSEs. On March 28, 2005, Moody's downgraded Fannie Mae's BFSR to B+. Based on Moody's mapping of BFSRs to Moody's basic credit assessment ratings, A- is the equivalent of an Aa1 and B+ maps to an Aa2.

Both the risk to government rating and the BFSR (collectively, financial strength ratings) are issuer ratings that evaluate the financial strength of each GSE without respect to any implied financial assistance from the U.S. government. These financial strength ratings are published and monitored by the issuing NRSRO but they are not included in the NRSROs' transition matrices. These ratings are an indicator of each GSE's overall financial condition and safety and soundness and, thus, do not apply to any specific financial obligation or the probability of timely payment thereof.[24] If the Agencies were to use these S&P and Moody's financial strength ratings to risk weight exposures to Fannie Mae and Freddie Mac in a manner similar to the use of external ratings for rated exposures as proposed in the Basel IA NPR, the current ratings would map to a 20 percent risk weight.

<u>Question 5: The Agencies are considering whether to use financial strength ratings to determine risk weights for exposures to GSEs, where this type of rating is available, and are seeking comment how a financial strength rating might be applied. For example, should the</u>

[24] Moody's and S&P's financial strength ratings would not meet the definition of an "external rating" as proposed forth in this NPR. Furthermore, the difficulty of defining an event of default and the lack of default data suggest that it would not be feasible to incorporate this type of rating into a transition matrix.

financial strength rating be mapped to the non-sovereign risk weights in Tables 1 and 2? Should these ratings apply to all GSE exposures including short- and long-term debt, mortgage-backed securities, collateral, and guarantees? How should exposures to a GSE that lacks a financial strength rating be risk weighted? Are there any requirements in addition to publication and on-going monitoring that should be incorporated into the definition of an acceptable financial strength rating?

Question 6: The Agencies also seek comment on whether to exclude certain other externally rated exposures from the ratings treatment as proposed or to use external ratings as a measure for additional externally rated exposures, collateral, and guarantees. Should the proposed ratings treatment be applicable for direct exposures to public sector entities or depository institutions? Likewise, should the proposed ratings treatment be applicable to exposures guaranteed by public sector entities or depository institutions, and to exposures collateralized by debt securities issued by those entities?

D. Mortgage Loans Secured by a Lien on a One-to-Four Family Residential Property

i. First Lien Risk Weights

The Agencies' existing risk-based capital rules assign first-lien, one-to-four family residential mortgages to either the 50 percent or 100 percent risk weight category. Most mortgage loans secured by a first lien on a one-to-four family residential property (first lien mortgages) meet the criteria to receive a 50 percent risk weight.[25] The broad assignment of most first lien mortgages to the 50 percent risk weight category has been criticized for not being sufficiently risk sensitive.

[25] 12 CFR part 3 appendix A section 3(c)(iii) (OCC); 12 CFR parts 208 and 225 appendix A section III.C.3 (Board); 12 CFR part 325, appendix A, section II.C.3 (FDIC); and 12 CFR 567.1 (definition of "qualifying mortgage loan") and 12 CFR 567.6(a)(1)(iii)(B) (50 percent risk weight) (OTS).

In the Basel IA ANPR, the Agencies stated they were considering options to make the risk-based capital requirement for residential mortgages more risk sensitive while not unnecessarily increasing regulatory burden. One option was to base the capital requirement on loan-to-value ratios (LTV), determined after consideration of private mortgage insurance (PMI). This option was illustrated by an LTV risk weight table that suggested risk weights of 20, 35, 50, and 100 percent.

Another option discussed in the Basel IA ANPR was to assign risk weights based on LTV in combination with an evaluation of borrower creditworthiness. Under this scenario, different ranges of LTV could be paired with specified credit assessments, such as credit scores. A first lien mortgage with a lower LTV made to a borrower with higher creditworthiness would receive a lower risk weight than a loan with higher LTV made to a borrower with lower creditworthiness.

The Agencies received many comments about how to risk weight first lien mortgages. Many commenters cautioned against rules that would be burdensome and costly to implement. Commenters generally supported the use of LTV and stated that use of LTV in assigning risk weights would not be overly burdensome because LTV information is collected when lenders originate mortgage loans.

Some commenters supported the use of a matrix based on LTV and a measure of creditworthiness, to further improve the risk sensitivity of the risk weights assigned to residential mortgage loans. They stated that this approach would address both collateral and borrower risk and would mirror current practices among mortgage lenders. Other commenters expressed concern about the potential burden of this approach, particularly for smaller banking organizations. Some commenters noted that certain credit assessment measures such as credit-scoring models vary by region or credit reporting agency, and may harm lower income borrowers, borrowers without credit histories, and borrowers who have experienced unusual financial difficulties. Many of these commenters suggested that the use of credit scores as a measure of borrower creditworthiness be optional to alleviate the burden for some smaller banking organizations.

To increase the risk sensitivity of the existing risk-based capital rules while minimizing the overall burden to banking organizations, the Agencies are proposing to risk weight first lien mortgages based on LTV. LTV is a meaningful indicator of potential loss and the likelihood of borrower default. Consequently, under this proposal a banking organization would assign a risk weight for a first lien mortgage, including mortgages held for sale and mortgages held in portfolio as outlined in Table 3.

Table 3: Proposed LTV and Risk Weights for 1-4 Family First Liens

Loan-to-Value Ratios (in percent)	**Risk Weight** (in percent)
60 or less	20
Greater than 60 and less than or equal to 80	35
Greater than 80 and less than or equal to 85	50
Greater than 85 and less than or equal to 90	75
Greater than 90 and less than or equal to 95	100
Greater than 95	150

The Agencies believe the implementation of this proposed approach would not impose a significant burden on banking organizations because LTV information is readily available and is commonly used in the underwriting process.

The Agencies believe that the use of LTV would enhance the risk sensitivity of regulatory capital but it remains a fairly simple measurement of risk. Use of LTV in risk weighting first lien mortgages does not substitute for, or otherwise release a banking organization from, its obligation to have prudent loan underwriting and risk management practices that are consistent with the size, type, and risk of a mortgage product. Through the supervisory process, the Agencies would continue to ensure that banking organizations engage in prudent underwriting and risk management practices consistent with existing rules, supervisory guidance, and safety and soundness. The Agencies would continue to reserve the authority to require banking organizations to hold additional capital where appropriate.

In general, Table 3 would apply to first lien mortgages. The Agencies would maintain their respective risk-based capital criteria for a first lien mortgage (for example, prudent underwriting) to receive a risk weight less than 100 percent.[26] Table 3 would not apply to loans to builders secured by certain pre-sold properties, which are subject to a statutory 50 percent risk weight.[27] Other loans to builders for the construction of residential property would continue to be subject to a 100 percent risk weight. The Agencies would maintain their respective capital treatment for a one-to-four family residential mortgage loan to a borrower for the construction of

[26] 12 CFR part 3 appendix A, section 3(3)(iii) (OCC); 12 CFR Parts 208 and 225, appendix A, section III.C.3 (Board); 12 CFR part 325, appendix A, section II.C.3 (FDIC); and 12 CFR 567.1 (definition of "qualifying mortgage loan") and 12 CFR 567.6(a)(1)(iii)(B) (50 percent risk weight) (OTS).

[27] This statutory risk weight applies to loans to builders secured by one-to-four family residential properties with substantial project equity for the construction of one-to-four family residences that have been pre-sold under firm contracts to purchasers who have obtained firm commitments for permanent qualifying mortgage loans and have made substantial earnest money deposits. See Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991, Pub. L. No. 102-233, § 618(a), 105 Stat. 1761, 1789-91 (codified at 12 U.S.C. 1831n note (1991)).

the borrower's own home.[28] Question 7: The Agencies seek comment on all aspects of using LTV to determine the risk weights for first lien mortgages.

The Agencies' existing risk-based capital rules place certain privately-issued mortgage-backed securities that do not carry the guarantee of a government or a government-sponsored entity (for example, unrated senior positions) in the 50 percent risk weight category, provided the underlying mortgages would qualify for a 50 percent risk weight. The Agencies intend to continue to risk weight these privately-issued mortgage-backed securities using the risk weights assigned to underlying mortgages under the Agencies' existing capital rules. Question 8: The Agencies seek comment on this treatment and other methods for risk-weighting these privately-issued mortgage-backed securities, including the appropriateness of assigning risk weights to these securities based on the risk weights of the underlying mortgages as determined under Table 3.

While the Agencies are not proposing to use LTV and borrower creditworthiness to risk weight mortgages, the Agencies continue to evaluate approaches that would consider borrower creditworthiness in risk weighting first lien mortgages. One such approach could use LTV and a measure of borrower creditworthiness to assign risk weights in a manner similar to that shown in Table 3A below. Table 3A would assign a lower risk weight to mortgages with a lower LTV that are underwritten to borrowers with a stronger credit history and a higher risk weight to mortgages with a higher LTV that are underwritten to borrowers with a weaker credit history.

Table 3A: Illustrative Risk-Weight Ranges for LTV and Credit History for 1-4 Family First Liens

[28] 12 CFR part 3 appendix A, section 3(3)(iv) (OCC); 12 CFR parts 208 and 225, appendix A, section III.C.3. (Board); 12 CFR part 325, appendix A, section II.C.3 (FDIC); and 12 CFR 567.1 (definition of "qualifying mortgage loan") (OTS).

First Lien Mortgages	**Illustrative Risk Weight Ranges**		
Loan-to-Value Ratios (in percent)	**Credit History Group 1** (in percent)	**Credit History Group 2** (in percent)	**Credit History Group 3** (in percent)
60 or less	20-35	20-35	20-35
Greater than 60 and less than or equal to 80	20-35	20-35	35-75
Greater than 80 and less than or equal to 90	20-50	35-75	75-150
Greater than 90 and less than or equal to 95	20-50	50-100	100-200
Greater than 95	35-75	50-100	150-200

Table 3A presents three broad categories of relative credit performance (credit history groups). The Agencies would determine the credit history groups using default odds. The default odds would be based upon credit reporting agencies' validation charts (also known as odds tables). A banking organization would determine a borrower's default odds by mapping the borrower's credit score, as obtained from a credit reporting agency[29], to the credit reporting agency's validation chart. In order for a validation chart to qualify, it would be based on: (1) the same vendor and model as the credit scores used by the banking organization, (2) a nationally diverse group of credits, and (3) relevant default odds measured over no less than 18 months following the scoring date used in the validation chart. If the Agencies decide in the final rule to risk weight first lien mortgages based on LTV and borrower creditworthiness, the Agencies would generally determine a specific risk weight based on the ranges provided in Table 3A.

Question 9: While the Agencies are not proposing to use LTV and borrower creditworthiness to risk weight mortgages, the Agencies may decide to risk weight first lien mortgages based on LTV and borrower creditworthiness in the final rule. Accordingly, the Agencies continue to seek comment on an approach using LTV combined with credit scores for determining risk-based capital. More specifically, the Agencies seek comment on: operational

[29]See 15 U.S.C. 1681a(f), which defines a credit reporting agency.

aspects for assessing the use of default odds to determine creditworthiness qualifications to determine acceptable models for calculating the default odds; the negative performance criteria against which the default odds are determined (that is, 60-days past due, 90-days past due, etc.); regional disparity, especially for a banking organization whose borrowers are not geographically diverse; and how often credit scores should be updated. In addition, the Agencies seek comment on determining the proper credit history group for: an individual with multiple credit scores, a loan with multiple borrowers with different probabilities of default, an individual whose credit history was analyzed using inaccurate data, and individuals with insufficient credit history to calculate a probability of default.

ii. Calculation of LTV

The Agencies sought comment on whether LTV should be based on LTV at origination or should be periodically updated. Some commenters supported using LTV at origination only. These commenters stated that regularly updating and monitoring LTV would be unduly burdensome and costly. Other commenters said the Agencies should require periodic updates, especially during significant declines in housing values in a banking organization's service area. Some commenters said that banking organizations should be able to update LTV at their discretion. Certain commenters suggested that updates be based on periodic property appraisals and loan balance updates. However, a number of commenters expressed concern about the reliability of appraisals, especially in over-heated markets.

Commenters had varying opinions about how the Agencies should factor PMI into the LTV calculations. Most of the commenters that addressed the issue supported calculating LTV net of loan-level PMI coverage. However, some commenters suggested that the Agencies should also consider the risk mitigation benefits of pool-level PMI. A few commenters suggested considering PMI issued only by highly rated insurers. One commenter endorsed a Basel IA ANPR suggestion to create risk-weight floors for mortgages supported by loan-level PMI from highly rated insurers. Another commenter suggested considering PMI issued by non-affiliate insurers only.

In proposing the LTV calculation method, the Agencies aim to balance burden and costs against the benefits of a more risk sensitive risk-weighting system. The Agencies propose to calculate LTV at origination of the first mortgage as follows. First, the value of the property would be equal to the lower of the purchase price for the property or the value at origination. The value at origination must be based on an appraisal or evaluation of the property in conformance with the Agencies' appraisal regulations[30] and real estate lending guidelines.[31] The value of the property could only be updated for risk-weight purposes when the borrower refinances its mortgage and the banking organization extends additional funds. Second, for loans that are positively amortizing, banking organizations may adjust the LTV quarterly to reflect any decrease in the principal balance. For loans that negatively amortize, banking organizations would be required to adjust the LTV quarterly to reflect the increase in principal balance and risk weight the loan based on the updated LTV. However, where property values in a banking organization's market subsequently experience a general decline in value, the Agencies continue to reserve their authority to require additional capital when warranted for supervisory reasons. The Agencies emphasize that the updating of LTV for regulatory capital purposes is not intended to replace good risk management practices at banking organizations for situations where more frequent updates of loan or property values might be appropriate.

[30] 12 CFR part 34 (OCC); 12 CFR part 208, subpart E and part 225, subpart G (Board); 12 CFR part 323, 12 CFR part 365 (FDIC); and 12 CFR part 564 (OTS).
[31] 12 CFR part 34 Subpart C.43 (OCC); 12 CFR part 208, subpart E and part 225, subpart G (Board); 12 CFR part 325, appendix A, section II.C.3 (FDIC);12 CFR 560.100 - 560.101 (OTS).

Question 10: The Agencies seek comment on whether there are other circumstances under which LTV should be adjusted for risk-weight purposes.

The Agencies believe that the risk mitigating impact of loan-level PMI should be reflected in calculating the LTV. Loan-level PMI is insurance that protects a mortgage lender in the event of borrower default up to a predetermined portion of the value of a one-to-four family residential property provided that there is no pool-level cap. A pool-level cap would effectively reduce coverage to any amount less than the predetermined portion. PMI would be recognized only if the loan-level insurer is not affiliated with the banking organization and has long-term senior debt (without credit enhancement) externally rated at least the third highest investment grade by an NRSRO. The Agencies believe that pool-level PMI should not generally reduce the LTV, because pool-level PMI absorbs losses based on a portfolio basis and is not attributable to a given loan.

Question 11: The Agencies request comment on all aspects of PMI including, whether PMI providers must be non-affiliated companies of the banking organization. The Agencies also seek comment on the treatment of PMI in the calculation of LTV when the PMI provider is not an affiliate, but a portion of the mortgage insurance is reinsured by an affiliate of the banking organization.

iii. Non-Traditional Mortgage Products

The Basel IA ANPR sought comment on whether mortgages with non-traditional features pose unique risks that warrant higher risk-based capital requirements. Non-traditional loan features include the possibility of negative amortization of the loan balance, a borrower's option to make interest-only payments, and interest rate reset provisions that may result in significant payment shock to the borrower.

Commenters generally supported risk weighting mortgage loans with non-traditional features consistently with the risk weighting for traditional first lien mortgages. These commenters suggested that any additional risks posed by these mortgage products were the result of imprudent underwriting practices or the combining of risks, not risks inherent in the products. One commenter, however, supported higher capital requirements for all non-traditional mortgage loans. Other commenters supported additional capital for specific products, such as negative amortization loans.

The Agencies recognize the difficultly in providing a clear and consistent definition of higher-risk mortgage loans with non-traditional features. Thus, the Agencies generally propose to risk weight first lien mortgages with non-traditional features in the manner described above. Notwithstanding this proposed treatment, the Agencies recognize that certain underwriting practices may increase the risk associated with a particular mortgage product. These practices may include underwriting of loans with less stringent income and asset verification requirements without offsetting mitigating factors; offering loans with very low introductory rates and short adjustment periods that may result in significant payment shock; and combining first lien loans with simultaneous junior lien loans that could result in an aggregate loan obligation with little borrower equity and the potential for a sizeable payment increase. The Agencies will continue to review banking organizations' lending practices on a case-by-case basis and may require additional capital or reserves in appropriate circumstances.

Loans with a negative amortization feature pose additional risks to a banking organization in the form of an unfunded commitment. Therefore, the Agencies propose to risk weight mortgage loans with negative amortization features consistent with the risk-based capital treatment for other unfunded commitments (for example, lines of credit). Under the proposed approach, the unfunded portion of the maximum negative amortization amount would be risk weighted separately from the funded portion of the loan. The funded portion of the loan would be risk weighted according to the risk weights for first-lien mortgages, and the unfunded portion of the maximum negative amortization amount would be risk weighted as a commitment based on the LTV for the maximum contractual loan amount.

Therefore, banking organizations would need to calculate two LTVs for a loan with a negative amortization feature for risk-based capital purposes: the LTV for the funded commitment and the LTV for the unfunded commitment. To demonstrate how loans with negative amortization features would be risk weighted, assume that a property is valued at $100,000 and the banking organization grants a first-lien loan for $81,000 that includes a negative amortization feature with a 10 percent cap. The funded amount of $81,000 results in an 81 percent LTV, which is risk weighted at 50 percent based on Table 3. In addition, the off-balance sheet unfunded commitment of $8,100 would receive a 50 percent credit conversion factor (CCF) resulting in an on-balance sheet credit equivalent amount of $4,050. The combined LTV of the funded and unfunded commitment would be 89.1 percent, hence $4,050 would receive a 75 percent risk weight based on Table 3. The total risk-weighted assets for the first-lien mortgage with negative amortization feature would equal the risk-weighted assets for the funded amount plus the risk-weighted assets for the unfunded amount.

That loan would be risk weighted at origination as follows**:**

Table 4: Example of Proposed Risk Based Capital Calculation for Mortgages with Negative Amortization Features

Funded Risk-Weighted Assets Calculation	
1) Amount to Risk Weight	$81,000
2) Funded LTV = Funded Loan Amount / Property Value = $81,000 / $100,000 =	81%
3) Risk weight based on Table 3	50%
4) RW Assets for Funded Loan Amount $81,000 x .50 =	$40,500
Unfunded Risk-Weighted Assets Calculation	
1) Amount to risk weight = Unfunded maximum amount * CCF = $8,100 x .50 =	$4,050
2) Unfunded LTV = Funded Loan Amount + Unfunded loan amount / Property Value = $81,000 +$8,100 / $100,000 =	89.1%
3) Risk Weight Based on Table 3	75%
4) RW Assets for Unfunded Amount = $4,050 x .75	$3,038
Total Risk-Weighted Assets for a Loan with Negative Amortizing Features	
RW Assets for Funded Amount + RW for Unfunded Amount = $40,500 + $3,038 = (Note: the funded and unfunded amount of the loan will change over time once the loan begins to negatively amortize)	$43,538

The Agencies believe that this approach would result in a risk-based capital charge that more accurately reflects the risk of mortgage loans with negative amortization features.

Question 12: The Agencies seek comment on the proposed risk-based capital treatment for all mortgage loans with non-traditional features and, in particular the proposed approach for mortgage loans with negative amortization features. The Agencies also seek comment on whether the maximum contractual amount is the appropriate measure of the unfunded exposure to loans with negative amortization features. The Agencies seek comment on whether the unfunded commitment for a reverse mortgage should be subject to a similar risk-based capital charge.

iv. Junior Lien One-to-Four Family Residential Mortgages

The Basel IA ANPR discussed the existing treatment for home equity lines of credit (HELOCs) and other junior lien mortgages.[32] If a banking organization holds both a first and a junior lien, and no other party holds an intervening lien, the Agencies' existing capital rules require these loans to be combined to determine the LTV and then risk weighted as a first lien mortgage. The Basel IA ANPR indicated that the Agencies intended to continue this approach.

Currently, stand-alone junior lien mortgages (a stand-alone junior lien mortgage is one where an institution holds a second or more junior lien without holding all of the more senior liens) receive a 100 percent risk weight. The Basel IA ANPR indicated that the Agencies were considering retaining this risk weight for stand-alone junior lien mortgages where the LTV (computed by combining the loan amounts for the junior lien and all senior liens) does not exceed 90 percent. However, for stand-alone junior lien mortgages where the LTV of the combined liens exceeds 90 percent, the Agencies suggested that a risk weight higher than 100

[32] The unfunded portion of a HELOC that is a commitment for more than one year and that is not unconditionally cancelable is converted to an on-balance sheet asset using a 50 percent CCF. That amount plus the funded portion of the HELOC are added together to determine the amount of the HELOC that is combined with the first lien position and then risk weighted at either 50 percent or 100 percent. See generally, 12 CFR part 3 appendix A, section (b)(2) and (a)(3)(iii) (OCC); 12 CFR parts 208 and 225, appendix A, section III.C.3 and 12 CFR parts 208 and 225, appendix A, section III.D.2 (Board); 12 CFR part 325, appendix A, section II.D.2.b. (FDIC); and 12 CFR 567.6(a)(2)(ii)(B) (OTS).

percent might be appropriate in recognition of the elevated credit risk associated with these exposures.

Many commenters opposed this approach and suggested that a more risk-sensitive approach, similar to that proposed for first lien mortgages, would be more appropriate because not all stand-alone junior lien mortgages are riskier than first lien mortgages. Other commenters stated that the risk-based capital treatment of first and junior lien mortgages, regardless of whether the same banking organization holds both, should be consistent. In addition, many commented that it would be illogical and unjustifiable to impose higher risk weights (for example, 150 percent) for secured mortgage loans than for unsecured retail loans (for example, 100 percent).

Consistent with the existing risk-based capital rules, the Agencies propose that a banking organization that holds both the first and junior lien mortgages on a one-to-four family residential property, where there is no intervening lien, would assign the combined loans to the appropriate risk-weight category in Table 3 above, based on the loans' combined LTV. A banking organization that holds both the first and any subsequent liens may update the property value for calculation of the combined LTV of the senior loans and the junior lien if the organization obtains an appraisal or evaluation of the collateral in conformance with the Agencies' appraisal regulations and related guidelines at the origination of the junior lien mortgage.

For a stand-alone junior lien mortgage, the Agencies propose that a banking organization use the combined LTV of that loan and all senior loans to determine the appropriate risk weight for the junior lien. Using the combined LTV, a banking organization would risk weight the stand-alone junior lien based on Table 5.

Table 5: Proposed LTV and Risk Weights for 1-4 Family Junior Liens

Combined Loan-to-Value Ratios (in percent)	**Risk Weight** (in percent)
60 or less	75
Greater than 60 and less than or equal to 90	100
Greater than 90	150

The combined LTV for the funded portion of stand-alone junior liens where the first lien can negatively amortize would be calculated using the maximum contractual loan amount under the terms of the first lien mortgage plus the funded portion of the junior lien. The combined LTV for the unfunded portion of all junior liens where the first lien can negatively amortize would be calculated using the maximum contractual loan amount under the terms of the first lien mortgage plus the funded unfunded portions of the junior lien.

The Agencies propose that banking organizations will be required to hold capital for both the funded and unfunded portion of a HELOC. Banking organizations that hold a HELOC where there is no intervening lien would assign the first lien and funded portion of the HELOC to the appropriate risk weight category in Table 3 above, based on the loans' combined LTV using the senior loans and the funded portion of the HELOC. The unfunded portion of the HELOC would be subject to the appropriate CCF[33] and risk weighted, using Table 3, based on the combined LTV, (senior loans plus the funded and unfunded portions of the HELOC).

For stand-alone HELOCs, the funded and unfunded portion of the stand-alone HELOC would be risk weighted based on Table 5. The funded portion of a HELOC would receive a risk weight based on the combined LTV of all senior loans and funded portion of the HELOC. The unfunded portion of the HELOC would be subject to the appropriate CCF and risk weighted,

[33] The unfunded portion of a HELOC that is a commitment for more than one year and that is not unconditionally cancelable is converted to an on-balance sheet asset using a 50 percent CCF. If the unfunded portion of the HELOC is a commitment for less than a year or is unconditionally cancelable it is converted to an on-balance sheet credit equivalent using a 0 percent CCF.

using Table 5, based on the combined LTV of all senior loans and the funded portion of the HELOC and the unfunded portion of the HELOC.

Question 13: The Agencies request comment on the appropriateness of the proposed risk-based capital treatment for HELOCs including the burden of adjusting LTV as the borrower utilizes the HELOC.

While the Agencies are not proposing in this NPR to use LTV and borrower creditworthiness, they also continue to evaluate approaches that would consider borrower creditworthiness in risk weighting junior lien mortgages. The Agencies believe that greater risk sensitivity can be achieved by evaluating not only LTV but also borrower creditworthiness. If the Agencies decide in the final rule to risk weight junior lien mortgages based on LTV and a measure of borrower creditworthiness, the Agencies would generally determine a specific risk weight based on the ranges provided in Table 5A.

Question 14: Accordingly, the Agencies seek further comment on all aspects of the use of LTV and borrower creditworthiness to determine the risk weight for a junior lien mortgage.

Table 5A: Illustrative Risk-Weight Ranges for LTV and Credit History

For Junior Lien 1-4 Family Mortgages

Junior Liens/HELOCs	**Illustrative Risk Weight Ranges**		
Loan-to-Value Ratios (in percent)	**Credit History Group 1** (in percent)	**Credit History Group 2** (in percent)	**Credit History Group 3** (in percent)
60 or less	20 -50	75 - 150	150-200
Greater than 60 and less than or equal to 80	35 - 50	75 - 150	150-200
Greater than 80 and less than or equal to 90	35 - 75	75 - 200	200
Greater than 90 and less than or equal to 95	35 - 75	75 - 200	200
Greater than 95	35 - 75	75 - 200	200

v. Transitional Rule

Some commenters raised concerns about the cost and burden associated with recoding existing loans to conform to a new system. To minimize burden while moving toward a more risk-sensitive approach, the Agencies propose to allow banking organizations that choose to apply the proposed rule an option to continue to risk weight existing mortgage loans using the existing risk-based capital rules. The option would apply only to those loans that the banking organization owned at the time it chose to apply the proposed rules. The banking organization would be required to apply the transitional provision to all of its existing mortgage loans. A banking organization may not use this transitional treatment if it previously used Tables 3 or 5 to risk weight these existing loans.

E. Short-Term Commitments

Under the Agencies' existing risk-based capital rules, commitments with an original maturity of one year or less (short-term commitments) and commitments that are unconditionally cancelable[34] are generally converted to an on-balance sheet credit equivalent amount using a zero percent CCF. Accordingly, banking organizations extending short-term commitments or unconditionally cancelable commitments are not required to maintain risk-based capital against the credit risk inherent in these exposures. Short-term commitments that are eligible liquidity facilities that support asset-backed commercial paper (ABCP), however, are converted to on-balance sheet assets using a 10 percent CCF. Commitments with an original maturity of more than one year (long-term commitments), including eligible long-term liquidity facilities that support ABCP, are converted to on-balance sheet credit equivalent amounts using a 50 percent

[34] An unconditionally cancelable commitment is one that can be canceled for any reason at any time without prior notice. In the case of a home equity line of credit, the banking organization is deemed able to unconditionally cancel the commitment if it can, at its option, prohibit additional extensions of credit, reduce the line, and terminate the commitment to the full extend permitted by relevant Federal law.

CCF.

In the Basel IA ANPR, the Agencies noted that they were considering amending the risk-based capital requirements for short-term commitments. Even though commitments with an original maturity of one year or less expose banking organizations to a lower degree of credit risk than longer-term commitments, some credit risk exists. Thus, the Agencies suggested applying a 10 percent CCF to short-term commitments. The resulting credit equivalent amount would be risk-weighted according to the rating of the facility or the underlying asset(s) or the obligor, after considering any collateral and guarantees. The Agencies noted that they planned to retain the zero percent CCF for commitments that are unconditionally cancelable. The Agencies also sought comment on an alternative approach that would apply a single CCF (for example, 20 percent) to all commitments, both short- and long-term.

Almost universally, commenters agreed that unconditionally cancelable commitments should not receive a capital charge. However, commenters' recommendations varied about how to approach other short- and long-term commitments. Some commenters suggested that all commitments, except unconditionally cancelable commitments, should receive a 20 percent CCF, regardless of maturity. These commenters argued that this simple approach would ease burden and counterbalance new complexities within the Basel IA ANPR.

Conversely, several commenters suggested that the capital treatment should reflect the fact that short-term commitments are less risky than long-term commitments. Of these commenters, a few argued that short-term commitments should not receive any capital charge. A few others supported the Basel IA ANPR suggestion to apply a 10 percent CCF to short-term commitments and 50 percent CCF to long-term commitments. One commenter suggested using a 20 percent CCF for short-term commitments and a 50 percent CCF for long-term commitments.

In the Agencies' view, banking organizations that provide short-term commitments that are not unconditionally cancelable are exposed to credit risk that the existing risk-based capital rules do not adequately address. The Agencies also recognize that short-term commitments generally expose banking organizations to a lower degree of credit risk than long-term commitments, thereby justifying a CCF that is lower than the 50 percent CCF currently assigned to long-term commitments. Thus, the Agencies are proposing to assign a 10 percent CCF to short-term commitments. The resulting credit equivalent amount would then be risk-weighted according to the rating of the facility, the underlying assets, or the obligor, after considering any applicable collateral and guarantees. Commitments that are unconditionally cancelable would retain a zero percent CCF.

Finally, the Agencies are not proposing to apply a CCF to commitments to originate one-to-four family residential mortgage loans that are provided in the ordinary course of business. The Agencies believe these types of commitments present only minimal credit risk because of their short durations, the significant number that expire before being funded, and the large percentage of originations that are held for resale. In addition, commitments on held-for-sale mortgages are treated as derivatives and are accounted for at fair value on the balance sheet of the issuer, and therefore already receive a capital charge. Given these mitigating factors, the Agencies do not wish to impose the burden of determining risk weights by LTV during the short commitment period.

Question 15: The Agencies continue to seek comments on an alternative approach that would apply a single CCF of 20 percent to all commitments, both short- and long-term (that are not unconditionally cancelable), and the advantages and disadvantages of such an approach.

F. Assess a Risk-Based Capital Charge for Early Amortization

The Agencies' existing risk-based capital rules do not assess a capital charge for risks associated with early amortization of securitizations of revolving credits (for example, credit card receivables). When assets are securitized, the extent to which the selling or sponsoring entity transfers the risks associated with the assets depends on the structure of the securitization and the nature of the underlying assets. Early amortization provisions[35] in securitizations of revolving retail credit facilities increase the likelihood that investors will be repaid before being subject to any risk of significant credit losses. These provisions raise two concerns about the risks to banking organizations that sponsor securitizations with early amortization provisions: (1) the payment allocation formula can result in the subordination of the seller's interest in the securitized assets during early amortization, and (2) an early amortization event can increase a banking organization's capital and liquidity needs in order to finance new draws on the revolving credit facilities.

In recognition of the risks associated with these structures, the Agencies have proposed a capital charge on securitizations of revolving credit exposures with early amortization provisions in prior rulemakings. On March 8, 2000, the Agencies published a proposed rule on recourse and direct credit substitutes.[36] In that proposal, the Agencies proposed to apply a fixed CCF of

[35] An early amortization provision means a provision in the documentation governing a securitization that, when triggered, causes investors in the securitization exposures to be repaid before the original stated maturity of the securitization exposures, unless the provision is solely triggered by events not directly related to the performance of the underlying exposures or the originating banking organization (such as material changes in tax laws or regulations).

[36] 65 FR 12320 (March 8, 2000).

20 percent to the amount of assets under management in all revolving securitizations that contained early amortization features.[37] The preamble to the final Recourse Rule[38] reiterated the concerns with early amortization, indicating that the risks associated with securitization, including those posed by an early amortization feature, are not fully captured in the Agencies' capital rules. While the Agencies did not impose a risk-based capital charge for early amortization provisions in the final Recourse Rule, they indicated that they would revisit the issue at some point in the future.[39]

In the Basel IA ANPR, the Agencies suggested two approaches to address these risks. One option was to apply a flat CCF to off-balance sheet receivables in revolving securitizations with early amortization provisions. Alternatively, the Agencies suggested using a risk-sensitive methodology based on excess spread[40] compression. Under this methodology, the risk-based capital charge would increase as excess spread decreased and approached the early amortization trigger point.

Most commenters that addressed this issue opposed the application of any capital charge on the investors' interest in credit card securitizations. Of the few that supported such a charge, one recommended that the rules apply a flat CCF to securitizations with early amortization provisions, and four supported the approach based on excess spread.

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[37] Id. at 12330–12331.
[38] 66 FR 59614, 59619 (November 29, 2001).
[39] In October 2003, the Agencies issued another proposed rule that included a risk-based capital charge for early amortization. See 68 FR 56568, 56571–56573 (October 1, 2003). This proposal was based upon the Basel Committee's third consultative paper issued April 2003. When the Agencies finalized other unrelated aspects of this proposed rule in July 2004, they did not implement the early amortization proposal. The Agencies determined that the change was inappropriate because the capital treatment of retail credit, including securitizations of revolving credit, was subject to change as the Basel framework proceeded through the U.S. rulemaking process. 69 FR 44908, 44912–44913 (July 28, 2004).
[40] Excess spread means gross finance charge collections (including market interchange fees) and other income received by a trust or the special purpose entity (SPE) minus interest paid to investors in the securitization exposures, servicing fees, charge-offs, and other similar trust or SPE expenses.

The Agencies are proposing to apply an approach based on excess spread to all revolving securitizations of credits with early-amortization features. This capital charge would be assessed against the investors' interest (that is, the total amount of securities issued by a trust or special purpose entity to investors, which is the portion of the securitization that is not on the banking organization's balance sheet) and would be imposed only in the event that the excess spread has declined to a predetermined percentage of the trapping point. The capital required would increase as the level of excess spread approaches the early amortization trigger. The Agencies are proposing to compare the three-month average excess spread against the point at which the securitization trust would be required to trap excess spread in a spread or reserve account as a basis for the capital charge. To determine the excess spread trapping point and the appropriate CCF, a banking organization would divide the level of excess spread by the spread trapping point as described below. In securitizations that do not require excess spread to be trapped, or that specify a trapping point based primarily on performance measures other than the three-month average excess spread, the excess spread trapping point would be set for purposes of this proposed rule at 4.5 percent.

To calculate the securitization's excess spread trapping point ratio, a banking organization must first calculate the annualized three month ratio for excess spread as follows:

a. For each of the three months, divide the month's excess spread by the outstanding principal balance of the underlying pool of exposures at the end of each month.

b. Calculate the average ratio for the three months and convert the resulting ratio to a compound annual rate.

Then a banking organization must divide the annualized three month ratio for excess spread by the excess spread trapping point that is specified in the documentation for the securitization.

Finally, a banking organization must apply the appropriate CCF from Table 6 to the amount of investors' interest. The resulting on-balance sheet credit equivalent amount would be assigned to the risk weight category appropriate to the securitized assets.

Table 6: Early Amortization Credit Conversion Factors

Excess Spread Trapping Point Ratio	**CCF** (in percent)
133.33 percent of trapping point or more	0
Less than 133.33 percent to 100 percent of trapping point	5
Less than 100 percent to 75 percent of trapping point	15
Less than 75 percent to 50 percent of trapping point	50
Less than 50 percent of trapping point	100

Question 16: The Agencies solicit comment on the appropriateness of the 4.5 percent excess spread trapping point and on other types and levels of early amortization triggers used in securitizations of revolving exposures that should be considered, especially for HELOC securitizations. The Agencies also seek comment on whether a flat 10 percent CCF is a more appropriate capital charge for revolving securitizations with early amortization features.

G. Remove the 50 Percent Limit on the Risk Weight for Derivatives

Currently, the Agencies' risk-based capital rules permit banks to apply a maximum 50 percent risk weight to the credit equivalent amount of certain derivative contracts. The risk weight assigned to derivatives contracts was limited to 50 percent when the derivatives counterparty credit risk rule was finalized in 1995 because most derivative counterparties were highly rated and were generally financial institutions.[41] At the time, the Agencies noted that they intended to monitor the quality of credits in the interest rate and exchange rate markets to determine whether some transactions might merit a 100 percent risk weight.

[41] 60 FR 46169-46185 (September 5, 1995).

As the market for derivatives has developed, the types of counterparties acceptable to participants have expanded to include counterparties that the Agencies believe should receive a risk weight greater than 50 percent. Although the Basel IA ANPR did not discuss the limit on the risk weight for derivatives contracts, the Agencies have determined that it is appropriate to propose removing the 50 percent risk weight limit that applies to certain derivative contracts. In this proposed rule, the risk weight assigned to the credit equivalent amount of a derivative contract would be the risk weight assigned to the counterparty after consideration of any collateral or guarantees.

H. Small Loans to Businesses

The Agencies' existing risk-based capital rules generally assign business loans to the 100 percent risk weight category unless the credit risk is mitigated by an acceptable guarantee or collateral. Banking organizations and other industry participants have criticized the lack of sensitivity in the measurement of credit risk associated with these exposures and maintained that the current risk-based capital charge is greater than warranted for high quality loans to businesses.

In the Basel IA ANPR, the Agencies noted that they were considering a lower risk weight for certain business loans under $1 million on a consolidated basis to a single borrower (small loans to businesses). One alternative discussed in the Basel IA ANPR would allow small loans to businesses to be eligible for a lower risk weight if certain requirements were satisfied. These requirements would include, for example, full amortization over a period of seven years or less, performance according to the contractual provisions of the loan agreement, and full protection by collateral. The banking organization would also have to originate the loans according to its underwriting policies (or purchase loans that have been underwritten in a manner consistent with the banking organization's underwriting policies), which would have to include an acceptable assessment of the collateral and the borrower's financial condition and ability to repay the debt. The Agencies sought comment on whether this potential change would improve the risk sensitivity of the risk-based capital rules without unduly increasing complexity and burden.

The Agencies also suggested an alternative approach that would assess risk-based capital requirements for small loans to businesses based on a credit assessment of the principals of the business and their ability to service the debt. This alternative could be applied in those cases where the principals personally guarantee the loan. The Agencies sought comment on any alternative approaches for improving the risk sensitivity of the risk-based capital treatment for small loans to businesses, including the use of credit assessments, LTV, collateral, guarantees, or other methods for stratifying credit risk.

Most commenters supported a lower risk weight for small loans to businesses. However, it was apparent from the comments that there is no universal set of risk drivers used to measure credit risk for these loans. In addition, there was little agreement among commenters about how credit risk for these loans should be measured without generating undue burden.

One commenter asked the Agencies to create a small-business risk-based capital model that takes into account various risk drivers, including financing leverage, use of funds, loss modeling, and lending shelf and securitization. Another commenter recommended measuring credit risk based on results obtained by the Fair Isaac Small Business Scoring Service, which the commenter claimed allows businesses to assess the creditworthiness of the principals of a small business and of the ability of the small business to make repayment on credit obligations up to $750,000.

Another commenter suggested that small loans to businesses that are collateralized should be risk weighted according to the LTV using the ratio of the amount of the loan to the value of eligible collateral. This commenter suggested that non-collateralized loans should be risk-weighted according to several factors, including credit assessments of personal guarantors, loan terms, size of the loan, amortization schedule, and past history of the borrower. Other commenters offered similar suggestions that would use risk measures such as credit assessments and debt-to-income ratios.

Several commenters suggested that the dollar threshold for receiving a lower risk weight was too low. A few commenters suggested increasing the threshold to $2 million. One commenter suggested setting the threshold at $5 million and indexing it to inflation.

Although the Agencies are not making a specific proposal in this NPR, they are exploring options for permitting certain small loans to businesses that meet certain criteria to qualify for a 75 percent risk weight. The Agencies believe that the application of the 75 percent risk weight to loans to businesses should be limited to situations where the banking organization's consolidated business credit exposure to the individual or company is $1 million or less.

Second, the Agencies believe that to qualify for the lower risk weight, these loans should be personally guaranteed by the owner or owners of the business and that the loans should be fully collateralized by the assets of the business. The Agencies believe that these requirements provide prudential safeguards to ensure that the banking organization is in the position to minimize losses in the event of default.

Third, the Agencies are considering requiring that qualifying loans fully amortize over a period of no more than seven years. The full amortization requirement encourages conservative cash management practices by the borrower and ensures that the banking organization can monitor the continued ability of the business to service the debt. The Agencies have chosen a seven-year limitation to coincide with the maturity structure of many loans used to finance equipment purchases.

The Agencies are also considering criteria for short-term loans that do not amortize, such as working capital loans and other revolving lines of credit. Under one alternative, the Agencies would allow loans or draws from a revolving line of credit that matures within 18 months to forgo the amortization requirement to the extent that the loan is to be repaid from the anticipated proceeds of a previously established financial transaction and such proceeds are pledged for the repayment of the loan.

Fourth, the Agencies are considering requiring that the loans be (1) prudently underwritten in a manner that justifies the assessment of a lower-than-100 percent risk weight and (2) performing, that is, the loan payments must be current. Thus, consistent with prudential standards required for the underwriting of any small loans to businesses, the Agencies would require that a banking organization establish standards for assessing the quality and sufficiency of pledged collateral, the financial condition of the borrower, the financial condition of any guarantors to the loan, and the ability of the business to meet certain debt service coverage criteria. The Agencies would also set requirements for an acceptable debt service coverage ratio, that is, the ratio of net operating income divided by total loan payments or net operating cash flow divided by debt service cost. The Agencies are considering a minimum debt service coverage ratio of 1.3.

Finally, the Agencies are analyzing the need for additional qualifying criteria. Among other criteria, the Agencies might require that the loans have not been restructured to prevent a past due occurrence and that none of the proceeds of the loans are used to service any other outstanding loan obligation.

Question 17: The Agencies seek comment on this or other approaches that might improve the risk sensitivity of the existing risk-based capital rules for small loans to businesses.

I. Multifamily Residential Mortgages, Other Retail Exposures, Loans 90 Days or More Past Due or In Nonaccrual, and Commercial Real Estate (CRE) Exposures

In the Basel IA ANPR, the Agencies sought comment on the risk-based capital treatment for multifamily residential mortgages, other retail exposures, loans 90 days or more past due or in nonaccrual, and commercial real estate exposures. After considering the comments that addressed the Agencies' approaches to the risk-based capital treatment for these exposures, the Agencies have decided that any increase in risk sensitivity is outweighed by the additional burden that would result from the suggested approaches. Consequently, the Agencies are not proposing any changes in this NPR with respect to these exposures. The Agencies will continue to examine these issues and may address the risk-based capital treatment for these exposures at some future time.

Question 18: The Agencies remain interested in industry comments on any methods that would increase the risk sensitivity of the risk-based capital requirements for other retail exposures, particularly through the use of credit assessments, such as the borrower's credit score or ability to service debt. The Agencies are particularly interested in whether and how credit assessments might be applied consistently and uniformly in the determination of risk weights without creating undue burden.

J. Other Issues Raised by Commenters

Although the issue was not addressed in the Basel IA ANPR, several commenters suggested that the Agencies should conduct a study of the potential effects of any proposed revisions to the Agencies' existing risk-based capital rules. They asserted that such a study would help the Agencies better understand the potential costs and benefits of the potential revisions, and help compare the revisions to the Basel II framework.

The Agencies intend to analyze the potential impact of these proposed changes, as well as any changes to the proposals that may result from the public comment process. The Agencies may make changes to these proposals if warranted based on this impact analysis.

III. Possible Alternatives for Basel II Banking Organizations

As noted in the "Background" section, on September 25, 2006, the Agencies issued the Basel II NPR. The Basel II advanced capital adequacy framework proposed in the Basel II NPR is highly complex and is directed primarily at banking organizations with total consolidated assets of $250 billion or more, or total consolidated on-balance sheet foreign exposure of $10 billion or more, and other banks that opt in to the Basel II framework – referred to as "Basel II banking organizations." In the Basel II NPR, the Agencies requested comment on whether Basel II banking organizations should be permitted to use other credit and operational risk approaches similar to those provided under Basel II.

The Agencies seek comment on all aspects of the following questions and seek the perspectives of banking organizations of different sizes and complexity.

Question 19: To what extent should the Agencies consider allowing Basel II banking organizations the option to calculate their risk based capital requirements using approaches other than the Advanced Internal Ratings Based (A-IRB) approach for credit risk and the Advanced

Measurement Approach (AMA) for operational risk? What would be the appropriate length of time for such an option?

Question 20: If Basel II banking organizations are provided the option to use alternatives to the advanced approaches, would either this Basel IA proposal or the standardized approach in Basel II be a suitable basis for a regulatory capital framework for credit risk for those organizations? What modifications would make either of these proposals more appropriate for use by large complex banking organizations? For example, what approaches should be considered for derivatives and other capital markets transactions, unsettled trades, equity exposures, and other significant risks and exposures typical of Basel II banking organizations?

Question 21: The risk weights in this Basel IA proposal were designed with the assumption that there would be no accompanying capital charge for operational risk. Basel II, however, requires banking organizations to calculate capital requirements for exposure to both credit risk and operational risk. If the Agencies were to proceed with a rulemaking for a U.S. version of a standardized approach for credit risk, should operational risk be addressed using one of the three methods set forth in Basel II?

Question 22: What additional requirements should the Agencies consider to encourage Basel II banking organizations to enhance their risk management practices or their financial disclosures, if they are provided the option to use alternatives to the advanced approaches of the Basel II NPR?

IV. Regulatory Analysis

Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act, 5 U.S.C. 605(b) (RFA), the regulatory flexibility analysis otherwise required under section 604 of the RFA is not required if an agency certifies that the rule will not have a significant economic impact on a substantial number of small entities (defined for purposes of the RFA to include banking organizations with assets less than or equal to $165 million) and publishes its certification and a short, explanatory statement in the Federal Register along with its rule. Pursuant to section 605(b) of the RFA, the Agencies certify that this proposed rule will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not needed. The amendments to the Agencies' regulations described above are elective. They will apply only to banking organizations that opt to take advantage of the proposed revisions to the existing domestic risk-based capital framework and that will not be required to use the advanced approaches contained in the Basel II proposal.[42] The Agencies believe that banking organizations that elect to adopt these proposals will generally be able to do so with data they currently use as part of their credit approval and portfolio management processes. Banking organizations not exercising this option would remain subject to the current capital framework. The proposal does not impose any new mandatory requirements or burdens. Moreover, industry groups representing small banking organizations that commented on the Basel IA ANPR noted that small banking organizations typically hold more capital than is required by the capital rules and would prefer to remain under the existing risk-based capital framework. For these reasons, the proposal will not result in a significant economic impact on a substantial number of small entities.

OCC Executive Order 12866 Determination

Executive Order 12866 requires Federal agencies to prepare a regulatory impact analysis for agency actions that are found to be "significant regulatory actions." "Significant regulatory actions" include, among other things, rulemakings that "have an annual effect on the economy of

[42] 71 FR 55830 (September 25, 2006).

$100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities."[43] Regulatory actions that satisfy one or more of these criteria are referred to as "economically significant regulatory actions."

The OCC anticipates that the proposed rule will meet the $100 million criterion and therefore is an economically significant regulatory action. In conducting the regulatory analysis for an economically significant regulatory action, Executive Order 12866 requires each Federal agency to provide to the Administrator of the Office of Management and Budget's (OMB) Office of Information and Regulatory Affairs (OIRA):

- The text of the draft regulatory action, together with a reasonably detailed description of the need for the regulatory action and an explanation of how the regulatory action will meet that need;
- An assessment of the potential costs and benefits of the regulatory action, including an explanation of the manner in which the regulatory action is consistent with a statutory mandate and, to the extent permitted by law, promotes the President's priorities and avoids undue interference with State, local, and tribal governments in the exercise of their governmental functions;
- An assessment, including the underlying analysis, of benefits anticipated from the regulatory action (such as, but not limited to, the promotion of the efficient functioning of the economy and private markets, the enhancement of health and safety, the protection of the natural environment, and the elimination or reduction of discrimination or bias)

[43] Executive Order 12866 (September 30, 1993), 58 FR 51735 (October 4, 1993), as amended by Executive Order 13258, 67 FR 9385 (February 28, 2002). For the complete text of the definition of "significant regulatory action," see E.O. 12866 at section 3(f). A "regulatory action" is "any substantive action by an agency (normally published in the Federal Register) that promulgates or is expected to lead to the promulgation of a final rule or regulation, including notices of inquiry, advance notices of proposed rulemaking, and notices of proposed rulemaking." E.O. 12866 at section 3(e).

together with, to the extent feasible, a quantification of those benefits;

- An assessment, including the underlying analysis, of costs anticipated from the regulatory action (such as, but not limited to, the direct cost both to the government in administering the regulation and to businesses and others in complying with the regulation, and any adverse effects on the efficient functioning of the economy, private markets (including productivity, employment, and competitiveness), health, safety, and the natural environment), together with, to the extent feasible, a quantification of those costs; and
- An assessment, including the underlying analysis, of costs and benefits of potentially effective and reasonably feasible alternatives to the planned regulation, identified by the agencies or the public (including improving the current regulation and reasonably viable nonregulatory actions), and an explanation why the planned regulatory action is preferable to the identified potential alternatives.

Set forth below is a summary of the OCC's regulatory impact analysis, which can be found in its entirety at http://www.occ.treas.gov/law/basel.htm under the link of "Regulatory Impact Analysis for Risk-Based Capital Guidelines: Domestic Capital Modifications (Basel IA), Office of the Comptroller of the Currency, International and Economic Affairs (2006)."

[INSERT EXECUTIVE SUMMARY OF OCC ECONOMIC ANALYSIS]

OTS Executive Order 12866 Determination

[INSERT EXECUTIVE SUMMARY OF OTS ECONOMIC ANALYSIS]

OCC Executive Order 13132 Determination

The OCC has determined that this proposed rule does not have any Federalism implications, as required by Executive Order 13132.

Paperwork Reduction Act

[TO BE ADDED]

OCC and OTS Unfunded Mandates Reform Act of 1995 Determination

Section 202 of the Unfunded Mandates Reform Act of 1995, Public Law 104-4 (Unfunded Mandates Act) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of $100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. The OCC and OTS each has determined that this proposed rule will not result in expenditures by State, local, and tribal governments, or by the private sector, of $100 million or more. Accordingly, neither the OCC nor the OTS has prepared a budgetary impact statement or specifically addressed the regulatory alternatives considered.

Solicitation of Comments on Use of Plain Language

Section 722 of the GLBA requires the Federal banking agencies to use plain language in all proposed and final rules published after January 1, 2000. The Federal banking agencies invite comment on how to make this proposed rule easier to understand. For example:

- Have we organized the material to suit your needs? If not, how could this material be better organized?
- Are the requirements in the rule clearly stated? If not, how could the rule be more clearly stated?
- Do the regulations contain technical language or jargon that is not clear? If so, which language requires clarification?

- Would a different format (grouping and order of sections, use of headings, paragraphing) make the regulation easier to understand? If so, what changes to the format would make the regulation easier to understand?
- Would more, but shorter, sections be better? If so, which sections should be changed?
- What else could we do to make the regulation easier to understand?

List of Subjects

<u>12 CFR Part 3</u>

Administrative practice and procedure, Capital, National banks, Reporting and recordkeeping requirements, Risk.

<u>12 CFR Part 208</u>

Accounting, Agriculture, Banks, Banking, Confidential business information, Crime, Currency, Mortgages, Reporting and recordkeeping requirements, Securities.

<u>12 CFR Part 225</u>

Administrative practice and procedure, Banks, Banking, Holding companies, Reporting and recordkeeping requirements, Securities.

<u>12 CFR Part 325</u>

Administrative practice and procedure, Bank deposit insurance, Banks, banking, Capital adequacy, Reporting and recordkeeping requirements, Savings associations, State non-member banks.

<u>12 CFR Part 567</u>

Capital, Reporting and recordkeeping requirements, Savings associations.

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Chapter III

Authority and Issuance

For the reasons set out in the preamble, part 325 of chapter III of title 12 of the Code of Federal Regulations is proposed to be amended as follows:

PART 325--CAPITAL MAINTENANCE

1. The authority citation for part 325 continues to read as follows:

Authority: U.S.C. 1815(a), 1815(b), 1816, 1818(a), 1818(b), 1818(c), 1818(t), 1819 (Tenth), 1828(c), 1828(d), 1828(i), 1828(n), 1828(o), 1831o, 1835, 3907, 3909, 4808; Pub. L. 102--233, 105 Stat. 1761, 1789, 1790 (12 U.S.C. 1831n note); Pub. L. 102--242, 105 Stat. 2236, 2355, as amended by Pub. L. 103--325, 108 Stat. 2160, 2233 (12 U.S.C. 1828 note); Pub. L. 102--242, 105 Stat. 2236, 2386, as amended by Pub. L. 102-550, 106 Stat. 3672, 4089 (12 U.S.C. 1828 note).

Subpart A

§ 325.1 [Amended]

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The provisions of this part apply to those circumstances for which the Federal Deposit Insurance Act or this chapter requires an evaluation of the adequacy of an insured depository institution's capital structure. The FDIC is required to evaluate capital before approving various applications by insured depository institutions. The FDIC also must evaluate capital, as an essential component, in determining the safety and soundness of state nonmember banks it insures and supervises and in determining whether depository institutions are in an unsafe or unsound condition. This subpart A establishes the criteria and standards FDIC will use in calculating the minimum leverage capital requirement and in determining capital adequacy. In addition, appendices A, D, and E to part 325 (appendices A, D, and E) set forth the FDIC's risk-based capital policy statements and appendix B to this subpart includes a statement of policy on capital adequacy that provides interpretational guidance as to how this subpart will be administered and enforced. In accordance with subpart B of Part 325, the FDIC also must evaluate an institution's capital for purposes of determining whether the institution is subject to the prompt corrective action provisions set forth in section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o).

§ 325.2 [Amended]

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(s) Risk-weighted assets means total risk-weighted assets, as calculated in accordance with appendices A, D, or E to Part 325.

***

(w) Tier 1 risk-based capital ratio means the ratio of Tier 1 capital to risk-weighted assets, as calculated in accordance with appendices A, D, or E to Part 325.

***

(y) <u>Total risk-based capital ratio</u> means the ratio of qualifying total capital to risk-weighted assets, as calculated in accordance with appendices A, D, or E to Part 325.

§ 325.6 [Amended]

***

(d) Enforcement of a directive. (1) Whenever a bank fails to follow the directive or to submit or adhere to its capital adequacy plan, the FDIC may seek enforcement of the directive in the appropriate United States district court, pursuant to 12 U.S.C. 3907(b)(2)(B)(ii), in the same manner and to the same extent as if the directive were a final cease-and-desist order. In addition to enforcement of the directive, the FDIC may seek assessment of civil money penalties for violation of the directive against any bank, any officer, director, employee, agent, or other person participating in the conduct of the affairs of the bank, pursuant to 12 U.S.C. 3909(d).

(2) The directive may be issued separately, in conjunction with, or in addition to, any other enforcement mechanisms available to the FDIC, including cease-and-desist orders, orders of correction, the approval or denial of applications, or any other actions authorized by law. In addition to addressing a bank's minimum leverage capital requirement, the capital directive may also address minimum risk-based capital requirements that are to be maintained and calculated in accordance with appendices A, D, and E to this part 325.

Subpart B

§ 325.103 [Amended]

(a) Capital measures (1) For purposes of section 38 and this subpart the relevant capital measures shall be:

(A) The total risk-based capital ratio;

(B) The Tier 1 risk-based capital ratio; and

(C) The leverage ratio.

(b) Risk-based capital ratios. All state nonmember banks must maintain the minimum risk-based capital ratios as calculated under appendices A, D, or E to part 325 (and under appendix C to part 325, as applicable).

(1) Except as provided in subsection (3) of this paragraph (b), any state nonmember bank that does not use appendix D, as provided in section 1(b) of appendix D, must calculate its minimum risk-based capital ratios under appendix A.

(2) Any state nonmember bank that uses appendix D must calculate its minimum risk-based capital ratios under appendix D.

(3) Any state nonmember bank that does not use appendix D may elect to calculate its minimum risk-based capital ratios under appendix E. Any state nonmember bank that makes this election must comply with the notice procedures in appendix E.

2. A new Appendix E is added to Part 325 and reads as follows:

Appendix E to Part 325—Statement of Policy on Risk-Based Capital: Alternative Approach for Computing Risk-Weighted Assets and Off-Balance-Sheet Items

Capital adequacy is one of the critical factors that the FDIC is required to analyze when taking action on various types of applications and when conducting supervisory activities related to the safety and soundness of individual banks and the banking system. In view of this, the FDIC's Board of Directors has adopted Part 325 of its regulations, which sets forth (1) minimum standards of capital adequacy for insured state nonmember banks and (2) standards for determining when an insured bank is in an unsafe or unsound condition by reason of the amount of its capital.

This capital maintenance regulation was designed to establish, in conjunction with other federal bank regulatory agencies, uniform capital standards for all federally-regulated banking organizations, regardless of size. The uniform capital standards were based on ratios of capital to total assets. While those leverage ratios have served as a useful tool for assessing capital adequacy, the FDIC believes there is a need for a capital measure that is more explicitly and systematically sensitive to the risk profiles of individual banks. As a result, the FDIC's Board of Directors has adopted appendices A, D, and E that establish the minimum risk-based capital requirements for banks. This statement of policy does not replace or eliminate the existing Part 325 capital-to-total assets leverage ratios.

The framework set forth in appendices A, D, and E consists of (1) a definition of capital for risk-based capital purposes, and (2) a system for calculating risk-weighted assets. A bank's risk-based capital ratio is calculated by dividing its qualifying total capital base (the numerator of the ratio) by its risk-weighted assets (the denominator). [44]

In addition, when certain banks that engage in trading activities calculate their risk-based capital ratio under these appendices A, D, and E, they must also refer to appendix C of this part,

[44] Period-end amounts, rather than average balances, normally will be used when calculating risk-based capital ratios. However, on a case-by-case basis, ratios based on average balances may also be required if supervisory concerns render it appropriate.

which incorporates capital charges for certain market risks into the risk-based capital ratio. When calculating their risk-based capital ratio under these appendices A, D, and E, such banks are required to refer to appendix C of this part for supplemental rules to determine qualifying and excess capital, calculate risk-weighted assets, calculate market risk equivalent assets and add them to risk-weighted assets, and calculate risk-based capital ratios as adjusted for market risk.

This statement of policy applies to all *FDIC-insured state-chartered banks* (excluding insured branches of foreign banks) that have elected to use this appendix E and that are *not* members of the Federal Reserve System, hereafter referred to as "state nonmember banks," regardless of size, and to all circumstances in which the FDIC is required to evaluate the capital of a banking organization. Therefore, the risk-based capital framework set forth in this statement of policy will be used in the examination and supervisory process as well as in the analysis of applications that the FDIC is required to act upon.

The risk-based capital ratio focuses principally on broad categories of credit risk, however, the ratio does not take account of many other factors that can affect a bank's financial condition. These factors include overall interest rate risk exposure, liquidity, funding and market risks; the quality and level of earnings; investment, loan portfolio, and other concentrations of credit risk, certain risks arising from nontraditional activities; the quality of loans and investments; the effectiveness of loan and investment policies; and management's overall ability to monitor and control financial and operating risks, including the risk presented by concentrations of credit and nontraditional activities. In addition to evaluating capital ratios, an overall assessment of capital adequacy must take account of each of these other factors, including, in particular, the level and severity of problem and adversely classified assets as well as a bank's interest rate risk as measured by the bank's exposure to declines in the economic value of its capital due to changes in interest rates. For this reason, the final supervisory judgment on a bank's capital adequacy may differ significantly from the conclusions that might be drawn solely from the absolute level of the bank's risk-based capital ratio.

Unless a bank uses appendix D of this part, any state nonmember bank may elect to use the capital requirements set forth in this appendix E by filing the appropriate Schedule of the Consolidated Reports of Condition and Income (Call Reports) to calculate its risk-based capital requirements. After a bank has filed its quarterly Call Reports under this appendix E, the bank's election to use appendix E will be effective on the date of filing its Call Reports and will apply retrospectively to the quarter covered by the filing.

Any bank that has elected to use this appendix E to calculate its risk-based capital ratios may elect to use appendix A of this part to calculate its risk-based capital ratios by giving the FDIC prior notice. This election will not apply retrospectively to the current quarter, but will apply prospectively for the next quarter. After the notice becomes effective, the bank must use appendix A, and the bank must file all subsequent Call Reports in accordance with appendix A.

The FDIC reserves the authority to exclude a bank from coverage under this appendix E if the FDIC determines that the exclusion is appropriate based on the risk profile of the bank or would otherwise enhance the safety and soundness of the bank. The FDIC also reserves the authority to: (i) require a bank that has elected to use the capital requirements in appendix E to continue to use appendix E or (ii) require a bank that uses appendix A to calculate its risk-based capital requirements to instead use appendix E to calculate its capital requirements, if the FDIC determines that the exclusion from coverage under appendix A is appropriate based on the risk profile of the bank or would otherwise enhance the safety and soundness of the bank. In making a determination under this paragraph, the FDIC will apply notice and response procedures in the same manner as the notice and response procedures in 12 CFR 325.6(c).

For the purposes of this appendix E, the following definitions apply:

Affiliate means, with respect to a company, any company that controls, is controlled by, or is under common control with, the company. For purposes of this definition, a person or company controls a company if it:

(a) Owns, controls, or holds with power to vote 25 percent or more of a class of voting securities of the company; or

(b) Consolidates the company for financial reporting purposes.

Company means a corporation, partnership, limited liability company, business trust, special purpose entity, association, or similar organization.

Eligible guarantee means a guarantee provided by a third party eligible guarantor that:

(a) Is written and unconditional;

(b) Covers all or a pro rata portion of the contractual payments of the obligor on the reference exposure;

(c) Gives the beneficiary a direct claim against the protection provider;

(d) Is non-cancelable by the protection provider for reasons other than the breach of the contract by the beneficiary;

(e) Is legally enforceable against the protection provider in a jurisdiction where the protection provider has sufficient assets against which a judgment may be attached and enforced;

(f) Requires the protection provider to make payment to the beneficiary on the occurrence of a default (as defined in the guarantee) of the obligor on the reference exposure without first requiring the beneficiary to demand payment from the obligor; and

(g) If extended by a sovereign, is backed by the full faith and credit of the sovereign.

Eligible guarantor means a sovereign with senior long-term debt externally rated at least investment grade (without credit enhancements) by a nationally recognized statistical rating organization (NRSRO) [45] or a non-sovereign with senior long-term debt externally rated at least investment grade (without credit enhancements) by a NRSRO. A sovereign or non-sovereign rated less than investment grade by any NRSRO is not an eligible guarantor for purposes of this definition.

External rating means a credit rating that is assigned by a NRSRO to a claim or issuer, provided that the credit rating:

(a) Fully reflects the entire amount of credit risk with regard to all payments owed on the claim (that is, the rating must fully reflect the credit risk associated with timely repayment of principal and interest);

(b) Is monitored by the issuing NRSRO;

(c) Is published in an accessible public forum, for example, on the NRSRO's website and in financial media; and

(d) Is, or will be, included in the issuing NRSRO's publicly available ratings transition matrix which tracks the performance and stability (or ratings migration) of an NRSRO's issued external ratings for the specific type of claim (for example, corporate debt).

[45] A nationally recognized statistical rating organization is an entity recognized by the Division of Market Regulation of the Securities and Exchange Commission (or any successor Division) (Commission) as a nationally recognized statistical rating organization for various purposes, including the Commission's uniform net capital requirements for brokers and dealers (17 CFR 240.15c3-1).

Loan level private mortgage insurance (PMI) means insurance provided by a regulated mortgage insurance company, with senior long-term debt rated at least third-highest investment grade (without credit enhancements) by a NRSRO, that protects a mortgage lender in the event of the default of a mortgage borrower up to a predetermined portion of the value of a single one- to four-family residential property, provided the mortgage insurance company is not an affiliate of the bank and provided there is no pool-level cap that would effectively reduce coverage.

Non-sovereign means:

(a) A company (including a securities firm, insurance company, bank holding company, and savings and loan holding company), or

(b) A multilateral lending institution or regional development institution.

For purposes of this definition, non-sovereign does not include the United States (including U.S. Government Agencies); states or other political subdivisions of the United States and other OECD countries; U.S. Government-sponsored Agencies; or U.S. depository institutions and foreign banks. In addition, for purposes of determining the appropriate risk weight of claims on or guaranteed by qualifying securities firms that are collateralized by cash or securities issued or guaranteed by OECD central governments and that meet the requirements of section II.B.1.c of this appendix E, non-sovereign also does not include a qualifying securities firm.[46]

Securitization exposures include asset- and mortgage-backed securities, recourse obligations, direct credit substitutes, and residual interests (other than credit-enhancing interest-only strips).

Sovereign means a central government, including its departments and ministries, and the central bank. It does not include states, provinces, local governments, or other political subdivisions of a country, or commercial enterprises owned by a central government.

[46] See footnote 71.

For purposes of this appendix E, sovereign does not include the United States, U.S. Government agencies, or the U.S. central bank (including the twelve Federal Reserve banks). In addition, for purposes of determining the appropriate risk weight of claims on qualifying securities firms that are collateralized by securities issued or guaranteed by OECD central governments that meet the requirements of section II.B.1.c of this appendix E, sovereign does not include an OECD central government (including the United States).

Unconditionally cancelable means, with respect to a commitment-type lending arrangement, that a bank may, at any time, with or without cause, refuse to advance funds or extend credit under the facility. In the case of home equity lines of credit or mortgage lines of credit, a commitment is unconditionally cancelable if the bank can, at its option, prohibit additional extensions of credit, reduce the line, and terminate the commitment to the full extent permitted by applicable Federal law.

I. Definition of Capital for the Risk-Based Capital Ratio

A bank's qualifying total capital base consists of two types of capital elements: "core capital elements" (Tier 1) and "supplementary capital elements" (Tier 2). To qualify as an element of Tier 1 or Tier 2 capital, a capital instrument should not contain or be subject to any conditions, covenants, terms, restrictions, or provisions that are inconsistent with safe and sound banking practices.

A. The Components of Qualifying Capital (see Table I)

1. Core capital elements (Tier 1) consists of:

i. Common stockholders' equity capital (includes common stock and related surplus, undivided profits, disclosed capital reserves that represent a segregation of undivided profits, and foreign currency translation adjustments, less net unrealized holding losses on available for-sale equity securities with readily determinable fair values);

ii. Noncumulative perpetual preferred stock, [47] including any related surplus; and

iii. Minority interests in the equity capital accounts of consolidated subsidiaries.

(a) At least 50 percent of the qualifying total capital base should consist of Tier 1 capital. Core (Tier 1) capital is defined as the sum of core capital elements minus all intangible assets (other than mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships eligible for inclusion in core capital pursuant to § 325.5(f)), [48] minus credit-enhancing interest-only strips that are not eligible for inclusion in core capital pursuant to § 325.5(f)), minus any disallowed deferred tax assets, and minus any amount of nonfinancial equity investments required to be deducted pursuant to section II.B.(6) of this appendix E.

(b) Although nonvoting common stock, noncumulative perpetual preferred stock, and minority interests in the equity capital accounts of consolidated subsidiaries are normally included in Tier 1 capital, voting common stockholders' equity generally will be expected to be the dominant form of Tier 1 capital. Thus, banks should avoid undue reliance on nonvoting equity, preferred stock and minority interests.

[47] Preferred stock issues where the dividend is reset periodically based, in whole or in part, upon the bank's current credit standing, including but not limited to, auction rate, money market or remarketable preferred stock, are assigned to Tier 2 capital, regardless of whether the dividends are cumulative or noncumulative.

[48] An exception is allowed for intangible assets that are explicitly approved by the FDIC as part of the bank's regulatory capital on a specific case basis. These intangibles will be included in capital for risk-based capital purposes under the terms and conditions that are specifically approved by the FDIC.

(c) Although minority interests in consolidated subsidiaries are generally included in regulatory capital, exceptions to this general rule will be made if the minority interests fail to provide meaningful capital support to the consolidated bank. Such a situation could arise if the minority interests are entitled to a preferred claim on essentially low risk assets of the subsidiary. Similarly, although credit-enhancing interest-only strips and intangible assets in the form of mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships are generally recognized for risk-based capital purposes, the deduction of part or all of the credit-enhancing interest-only strips, mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships may be required if the carrying amounts of these assets are excessive in relation to their market value or the level of the bank's capital accounts. Credit-enhancing interest-only strips, mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships and deferred tax assets that do not meet the conditions, limitations and restrictions described in § 325.5(f) and (g) of this part will not be recognized for risk-based capital purposes.

(d) Minority interests in small business investment companies, investment funds that hold nonfinancial equity investments (as defined in section II.B.(6)(ii) of this appendix E), and subsidiaries that are engaged in nonfinancial activities are not included in a bank's Tier 1 or total capital base if the bank excludes the consolidated assets of such programs from risk-weighted assets pursuant to section II.B.(6)(ii) of this appendix.

2. Supplementary capital elements (Tier 2) consist of:

(i) Allowance for loan and lease losses, up to a maximum of 1.25 percent of risk-weighted assets;

(ii) Cumulative perpetual preferred stock, long-term preferred stock (original maturity of at least 20 years) and any related surplus;

(iii) Perpetual preferred stock (and any related surplus) where the dividend is reset periodically based, in whole or part, on the bank's current credit standing, regardless of whether the dividends are cumulative or noncumulative;

(iv) Hybrid capital instruments, including mandatory convertible debt securities;

(v) Term subordinated debt and intermediate-term preferred stock (original average maturity of five years or more) and any related surplus; and

(vi) Net unrealized holding gains on equity securities (subject to the limitations discussed in paragraph I.A.2.(f) of this section).

The maximum amount of Tier 2 capital that may be recognized for risk-based capital purposes is limited to 100 percent of Tier 1 capital (after any deductions for disallowed intangibles and disallowed deferred tax assets). In addition, the combined amount of term subordinated debt and intermediate-term preferred stock that may be treated as part of Tier 2 capital for risk-based capital purposes is limited to 50 percent of Tier 1 capital. Amounts in excess of these limits may be issued but are not included in the calculation of the risk-based capital ratio.

(a) Allowance for loan and lease losses. Allowances for loan and lease losses are reserves that have been established through a charge against earnings to absorb future losses on loans or lease financing receivables. Allowances for loan and lease losses exclude "allocated transfer risk reserves." [49] and reserves created against identified losses.

This risk-based capital framework provides a phasedown during the transition period of the extent to which the allowance for loan and lease losses may be included in an institution's capital base. By year-end 1990, the allowance for loan and lease losses, as an element of supplementary

[49] Allocated transfer risk reserves are reserves that have been established in accordance with section 905(a) of the International Lending Supervision Act of 1983 against certain assets whose value has been found by the U.S. supervisory authorities to have been significantly impaired by protracted transfer risk problems.

capital, may constitute no more than 1.5 percent of risk-weighted assets and, by year-end 1992, no more than 1.25 percent of risk-weighted assets. [50]

(b) Preferred stock. Perpetual preferred stock is defined as preferred stock that does not have a maturity date, that cannot be redeemed at the option of the holder, and that has no other provisions that will require future redemption of the issue. Long-term preferred stock includes limited-life preferred stock with an original maturity of 20 years or more, provided that the stock cannot be redeemed at the option of the holder prior to maturity, except with the prior approval of the FDIC.

Cumulative perpetual preferred stock and long-term preferred stock qualify for inclusion in supplementary capital provided that the instruments can absorb losses while the issuer operates as a going concern (a fundamental characteristic of equity capital) and provided the issuer has the option to defer payment of dividends on these instruments. Given these conditions, and the perpetual or long-term nature of the instruments, there is no limit on the amount of these preferred stock instruments that may be included with Tier 2 capital.

Noncumulative perpetual preferred stock where the dividend is reset periodically based, in whole or in part, on the bank's current credit standing, including auction rate, money market, or remarketable preferred stock, are also assigned to Tier 2 capital without limit, provided the above conditions are met.

(c) Hybrid capital instruments. Hybrid capital instruments include instruments that have certain characteristics of both debt and equity. In order to be included as supplementary capital

[50] The amount of the allowance for loan and lease losses that may be included as a supplementary capital element is based on a percentage of gross risk-weighted assets. A bank may deduct reserves for loan and lease losses that are in excess of the amount permitted to be included in capital, as well as allocated transfer risk reserves, from gross risk-weighted assets when computing the denominator of the risk-based capital ratio.

elements, these instruments should meet the following criteria:

(1) The instrument should be unsecured, subordinated to the claims of depositors and general creditors, and fully paid-up.

(2) The instrument should not be redeemable at the option of the holder prior to maturity, except with the prior approval of the FDIC. This requirement implies that holders of such instruments may not accelerate the payment of principal except in the event of bankruptcy, insolvency, or reorganization.

(3) The instrument should be available to participate in losses while the issuer is operating as a going concern. (Term subordinated debt would not meet this requirement.) To satisfy this requirement, the instrument should convert to common or perpetual preferred stock in the event that the sum of the undivided profits and capital surplus accounts of the issuer results in a negative balance.

(4) The instrument should provide the option for the issuer to defer principal and interest payments if: (a) the issuer does not report a profit in the preceding annual period, defined as combined profits (i.e., net income) for the most recent four quarters, *and* (b) the issuer eliminates cash dividends on its common and preferred stock.

Mandatory convertible debt securities, which are subordinated debt instruments that require the issuer to convert such instruments into common or perpetual preferred stock by a date at or before the maturity of the debt instruments, will qualify as hybrid capital instruments provided the maturity of these instruments is 12 years or less and the instruments meet the criteria set forth below for "term subordinated debt." There is no limit on the amount of hybrid capital instruments that may be included within Tier 2 capital.

(d) Term subordinated debt and intermediate-term preferred stock. The aggregate amount of term subordinated debt (excluding mandatory convertible debt securities) and intermediate-term preferred stock (including any related surplus) that may be treated as Tier 2 capital for risk-based capital purposes is limited to 50 percent of Tier 1 capital. Term subordinated debt and intermediate-term preferred stock should have an original average maturity of at least five years to qualify as supplementary capital and should not be redeemable at the option of the holder prior to maturity, except with the prior approval of the FDIC. For state nonmember banks, a "term subordinated debt" instrument is an obligation other than a deposit obligation that:

(1) Bears on its face, in boldface type, the following: This obligation is not a deposit and is not insured by the Federal Deposit Insurance Corporation;

(2)(i) Has a maturity of at least five years; or

(ii) In the case of an obligation or issue that provides for scheduled repayments of principal, has an average maturity of at least five years; provided that the Director of the Division of Supervision may permit the issuance of an obligation or issue with a shorter maturity or average maturity if the Director has determined that exigent circumstances require the issuance of such obligation or issue; provided further that the provisions of this paragraph I.A.2.(d)(2) shall not apply to mandatory convertible debt obligations or issues;

(3) States expressly that the obligation:

(i) Is subordinated and junior in right of payment to the issuing bank's obligations to its depositors and to the bank's other obligations to its general and secured creditors; and

(ii) Is ineligible as collateral for a loan by the issuing bank;

(4) Is unsecured;

(5) States expressly that the issuing bank may not retire any part of its obligation without any prior written consent of the FDIC or other primary federal regulator; and

(6) Includes, if the obligation is issued to a depository institution, a specific waiver of the right of offset by the lending depository institution.

Subordinated debt obligations issued prior to December 2, 1987 that satisfied the definition of the term "subordinated note and debenture" that was in effect prior to that date also will be deemed to be term subordinated debt for risk-based capital purposes. An optional redemption ("call") provision in a subordinated debt instrument that is exercisable by the issuing bank in less than five years will not be deemed to constitute a maturity of less than five years, provided that the obligation otherwise has a stated contractual maturity of at least five years; the call is exercisable solely at the discretion or option of the issuing bank, and not at the discretion or option of the holder of the obligation; and the call is exercisable only with the express prior written consent of the FDIC under 12 U.S.C. 1828(i)(1) at the time early redemption or retirement is sought, and such consent has not been given in advance at the time of issuance of the obligation. Optional redemption provisions will be accorded similar treatment when determining the perpetual nature and/or maturity of preferred stock and other capital instruments.

(e) <u>Discount of limited-life supplementary capital instruments</u>. As a limited-life capital instrument approaches maturity, the instrument begins to take on characteristics of a short-term obligation and becomes less like a component of capital. Therefore, for risk-based capital purposes, the outstanding amount of term subordinated debt and limited-life preferred stock eligible for inclusion in capital will be adjusted downward, or discounted, as the instruments approach maturity. Each limited-life capital instrument will be discounted by reducing the outstanding amount of the capital instrument eligible for inclusion as supplementary capital by a fifth of the original amount (less redemptions) each year during the instrument's last five years before maturity. Such instruments, therefore, will have no capital value when they have a remaining maturity of less than a year.

(f) Unrealized gains on equity securities and unrealized gains (losses) on other assets. Up to 45 percent of pretax net unrealized holding gains (that is, the excess, if any, of the fair value over historical cost) on available-for-sale equity securities with readily determinable fair values may be included in supplementary capital. However, the FDIC may exclude all or a portion of these unrealized gains from Tier 2 capital if the FDIC determines that the equity securities are not prudently valued. Unrealized gains (losses) on other types of assets, such as bank premises and available-for-sale debt securities, are not included in supplementary capital, but the FDIC may take these unrealized gains (losses) into account as additional factors when assessing a bank's overall capital adequacy.

B. Deductions from Capital and Other Adjustments.

Certain assets are deducted from a bank's capital base for the purpose of calculating the numerator of the risk-based capital ratio. [51] These assets include:

(1) All intangible assets other than mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships. [52] These disallowed intangibles are deducted from the core capital (Tier 1) elements.

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[51] Any assets deducted from capital when computing the numerator of the risk-based capital ratio will also be excluded from risk-weighted assets when computing the denominator of the ratio.

[52] In addition to mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships, certain other intangibles may be allowed if explicitly approved by the FDIC as part of the bank's regulatory capital on a specific case basis. In evaluating whether other types of intangibles should be recognized for regulatory capital purposes on a specific case basis, the FDIC will accord special attention to the general characteristics of the intangibles, including: (1) the separability of the intangible asset and the ability to sell it separate and apart from the bank or the bulk of the bank's assets, (2) the certainty that a readily identifiable stream of cash flows associated with the intangible asset can hold its value notwithstanding the future prospects of the bank, and (3) the existence of a market of sufficient depth to provide liquidity for the intangible asset.

(2) Investments in unconsolidated banking and finance subsidiaries. [53] This includes any equity or debt capital investments in banking or finance subsidiaries if the subsidiaries are not consolidated for regulatory capital requirements. [54] Generally, these investments include equity and debt capital securities and any other instruments or commitments that are deemed to be capital of the subsidiary. These investments are deducted from the bank's total (Tier 1 plus Tier 2) capital base.

(3) Investments in securities subsidiaries established pursuant to 12 CFR 337.4. The FDIC may also consider deducting investments in other subsidiaries, either on a case-by-case basis or, as with securities subsidiaries, based on the general characteristics or functional nature of the subsidiaries.

(4) Reciprocal holdings of capital instruments of banks that represent intentional cross-holdings by the banks. These holdings are deducted from the bank's total capital base.

(5) Deferred tax assets in excess of the limit set forth in § 325.5(g). These disallowed deferred tax assets are deducted from the core capital (Tier 1) elements.

On a case-by-case basis, and in conjunction with supervisory examinations, other deductions

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[53] For risk-based capital purposes, these subsidiaries are generally defined as any company that is primarily engaged in banking or finance and in which the bank, either directly or indirectly, owns more than 50 percent of the outstanding voting stock but does not consolidate the company for regulatory capital purposes. In addition to investments in unconsolidated banking and finance subsidiaries, the FDIC may, on a case-by-case basis, deduct investments in associated companies or joint ventures, which are generally defined as any companies in which the bank, either directly or indirectly, owns 20 to 50 percent of the outstanding voting stock. Alternatively, the FDIC may, in certain cases, apply an appropriate risk-weighted capital charge against a bank's proportionate interest in the assets of associated companies and joint ventures. The definitions for subsidiaries, associated companies and joint ventures are contained in the instructions for the preparation of the Consolidated Reports of Condition and Income.

[54] Consolidation requirements for regulatory capital purposes generally follow the consolidation requirements set forth in the instructions for preparation of the consolidated Reports of Condition and Income. However, although investments in subsidiaries representing majority ownership in another federally-insured depository institution are not consolidated for purposes of the consolidated Reports of Condition and Income that are filed by the parent bank, they are generally consolidated for purposes of determining FDIC regulatory capital requirements. Therefore, investments in these depository institution subsidiaries generally will not be deducted for risk-based capital purposes; rather, assets and liabilities of such subsidiaries will be consolidated with those of the parent bank when calculating the risk-based capital ratio. In addition, although securities subsidiaries established pursuant to 12 CFR 337.4 are consolidated for Report of Condition and Income purposes, they are not consolidated for regulatory capital purposes.

from capital may also be required, including any adjustments deemed appropriate for assets classified as loss.

II. Procedures For Computing Risk-Weighted Assets

A. General Procedures

1. Under the risk-based capital framework, a bank's balance sheet assets and credit equivalent amounts of off-balance sheet items are assigned to one of eight broad risk categories according to the obligor or, if relevant, the guarantor or the nature of the collateral. The aggregate dollar amount in each category is then multiplied by the risk weight assigned to that category. The resulting weighted values from each of the eight risk categories are added together and this sum is the risk-weighted assets total that, as adjusted,[55] comprises the denominator of the risk-based capital ratio.

2. The risk-weighted amounts for all off-balance sheet items are determined by a two-step process. First, the notional principal, or face value, amount of each off-balance sheet item generally is multiplied by a credit conversion factor to arrive at a balance sheet “credit equivalent amount." Second, the credit equivalent amount generally is assigned to the appropriate risk category, like any balance sheet asset, according to the obligor or, if relevant, the guarantor or the nature of the collateral.

3. The Director of the Division of Supervision and Consumer Protection (Director) of DSC may, on a case-by-case basis, determine the appropriate risk weight for any asset or credit

[55] Any asset deducted from a bank's capital accounts when computing the numerator of the risk-based capital ratio will also be excluded from risk-weighted assets when calculating the denominator for the ratio.

equivalent amount that does not fit wholly within one of the risk categories set forth in this appendix E or that imposes risks on a bank that are not commensurate with the risk weight otherwise specified in this appendix E for the asset or credit equivalent amount. In addition, the Director of DSC may, on a case-by-case basis, determine the appropriate credit conversion factor for any off-balance sheet item that does not fit wholly within one of the credit conversion factors set forth in this appendix E or that imposes risks on a bank that are not commensurate with the credit conversion factor otherwise specified in this appendix E for the off-balance sheet item. In making such a determination, the Director of DSC will consider the similarity of the asset or off-balance sheet item to assets or off-balance sheet items explicitly treated in sections II.B and II.C of this appendix E, as well as other relevant factors.

B. Other Considerations

1. Indirect Holdings of Assets. Some of the assets on a bank's balance sheet may represent an indirect holding of a pool of assets; for example, mutual funds. An investment in shares of a mutual fund whose portfolio consists solely of various securities or money market instruments that, if held separately, would be assigned to different risk categories, generally is assigned to the risk category appropriate to the highest risk-weighted asset that the fund is permitted to hold in accordance with the stated investment objectives set forth in its prospectus. The bank may, at its option, assign the investment on a pro rata basis to different risk categories according to the investment limits in the fund's prospectus, but in no case will indirect holdings through shares in any mutual fund be assigned to a risk weight less than 20 percent. If the bank chooses to assign its investment on a pro rata basis, and the sum of the investment limits in the fund's prospectus

exceeds 100 percent, the bank must assign risk weights in descending order. If, in order to maintain a necessary degree of short-term liquidity, a fund is permitted to hold an insignificant amount of its assets in short-term, highly liquid securities of superior credit quality that do not qualify for a preferential risk weight, such securities will generally be disregarded in determining the risk category to which the bank's holdings in the overall fund should be assigned. The prudent use of hedging instruments by a mutual fund to reduce the risk of its assets will not increase the risk weighting of the mutual fund investment. For example, the use of hedging instruments by a mutual fund to reduce the interest rate risk of its government bond portfolio will not increase the risk weight of that fund above the 20 percent category. Nonetheless, if the fund engages in any activities that appear speculative in nature or has any other characteristics that are inconsistent with the preferential risk weighting assigned to the fund's assets, holdings in the fund will be assigned to the 100 percent risk category.

2. Collateral (a) Cash and securities issued or guaranteed by the United States, other OECD central Governments and U.S. Government-sponsored entities. In determining risk weights of various assets, the following forms of collateral are formally recognized under appendix E: cash on deposit in the lending bank; securities issued or guaranteed by the United States, other central governments of the OECD-based group of countries, [56] U.S. Government agencies, and U.S.

[56] Securities issued or guaranteed by OECD central governments are only recognized under the zero percent risk weight if they meet the collateral requirements of section II.C.1 of appendix E. The OECD-based group of countries comprises all full members of the Organization for Economic Cooperation and Development (OECD) regardless of entry date, as well as countries that have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the IMF's General Arrangements to Borrow, but excludes any country that has rescheduled its external sovereign debt within the previous five years. As of November 1995, the OECD included the following countries: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States; and Saudi Arabia had concluded special lending arrangements with the IMF associated with the IMF's General Arrangements to Borrow. A rescheduling of external sovereign debt generally would include any renegotiation of terms arising from a country's inability or unwillingness to meet its external debt service obligations, but generally would not include renegotiations of debt in the normal course of business, such as renegotiation to allow the borrower to take advantage of a decline in interest rates or other change in market conditions.

Government-sponsored agencies. Claims fully secured by such collateral are assigned to the 20 percent risk category.[57] The extent to which these securities are recognized as collateral for risk-based capital purposes is determined by their current market value. If a claim is partially secured, the portion of the claim that is not covered by the collateral is assigned to the risk category appropriate to the obligor or, if relevant, the guarantor.

(b) Collateral that requires an external rating. The following forms of liquid and readily marketable financial collateral also are recognized: both short- and long-term debt securities that are either (1) issued or guaranteed by sovereigns where either the sovereign or the issued debt security are externally rated at least than investment grade by a NRSRO; (2) issued by non-sovereigns where the issued security is externally rated at least investment grade by a NRSRO; or (3) securitization exposures rated at least investment grade by a NRSRO. Claims or portion of claims collateralized by financial collateral externally rated at least investment grade are assigned to the risk weight appropriate to the collateral's external rating as set forth in section II.C.9(a) and Tables R1 and R2, or section II.B.5 and Tables A and B.[58]

The extent to which externally rated securities are recognized as collateral for risk-based capital purposes is determined by their current market value. If a claim is partially secured, the pro rata portion of the claim that is not covered by the collateral is assigned to the risk category appropriate to the obligor or, if relevant, the guarantor. Notwithstanding Tables R1 and R2 there is a 20 percent risk weight floor on collateral.

[57] However, claims on or guaranteed by qualifying securities firms may receive a zero percent risk weight if such claims are: (i) collateralized by cash or securities issued by an OECD central government (including the United States) and (ii) meet the other requirements of section II.C.1(c) of this appendix E. See footnote 74.

[58] In the event that the external rating of a security used to collateralize a claim results in a higher risk weight than would have otherwise been assigned based on the claim's underlying asset type, obligor, or external rating, if applicable, then the lower risk weight appropriate to the underlying asset type or the obligor may be applied.

3. Guarantees (a) Guarantees of the United States, U.S. Government-sponsored entities, OECD state and local governments, and certain banking organizations. Guarantees of the United States, U.S. Government agencies, U.S. Government-sponsored agencies, state and local governments of the OECD-based group of countries, U.S. depository institutions, and foreign banks in OECD countries are recognized under appendix E. If a claim is partially guaranteed, the portion of the claim that is not fully covered by the guarantee is assigned to the risk category appropriate to the obligor or, if relevant, the collateral.

(b) Eligible guarantees by sovereigns and non-sovereigns. A claim backed by an eligible guarantee may be assigned to the risk weight in section II.C.9(a) and Table R1 corresponding to the eligible guarantor(s)' senior long-term debt rating or issuer rating, in the case of a sovereign.

Portions of claims backed by an eligible guarantee may be assigned to the risk- weight category appropriate to the external credit rating of the eligible guarantor(s)' senior long-term debt or issuer rating in accordance with section II.C.9(a) and Table R1.

4. Maturity. Maturity is generally not a factor in assigning items to risk categories with the exceptions of claims on non-OECD banks, commitments, and interest rate and foreign exchange rate related contracts. Except for commitments, short-term is defined as one year or less remaining maturity and long-term is defined as over one year remaining maturity. In the case of commitments, short-term is defined as one year or less original maturity and long-term is defined as over one year original maturity.

5. Recourse, Direct Credit Substitutes, Residual Interests and Mortgage- and Asset-Backed Securities. For purposes of this section II.B.5 of this appendix E, the following definitions will apply.

(a) Definitions. (1) Credit derivative means a contract that allows one party ("the protection purchaser") to transfer the credit risk of an asset or off-balance sheet credit exposure to another party (the protection provider). The value of a credit derivative is dependent, at least in part, on the credit performance of the "reference asset."

(2) Credit-enhancing interest-only strip is defined in § 325.2(g).

(3) Credit-enhancing representations and warranties means representations and warranties that are made or assumed in connection with a transfer of assets (including loan servicing assets) and that obligate a bank to protect investors from losses arising from credit risk in the assets transferred or the loans serviced. Credit-enhancing representations and warranties include promises to protect a party from losses resulting from the default or nonperformance of another party or from an insufficiency in the value of the collateral. Credit-enhancing representations and warranties do not include:

(i) Early default clauses and similar warranties that permit the return of, or premium refund clauses covering, 1--4 family residential first mortgage loans that qualify for a 50 percent risk weight for a period not to exceed 120 days from the date of transfer. These warranties may cover only those loans that were originated within 1 year of the date of transfer;

(ii) Premium refund clauses that cover assets guaranteed, in whole or in part, by the U.S. Government, a U.S. Government agency or a government-sponsored enterprise, provided the premium refund clauses are for a period not to exceed 120 days from the date of transfer; or

(iii) Warranties that permit the return of assets in instances of misrepresentation, fraud or incomplete documentation.

(4) Direct credit substitute means an arrangement in which a bank assumes, in form or in substance, credit risk associated with an on- or off-balance sheet credit exposure that was not

previously owned by the bank (third-party asset) and the risk assumed by the bank exceeds the pro rata share of the bank's interest in the third-party asset. If the bank has no claim on the third-party asset, then the bank's assumption of any credit risk with respect to the third party asset is a direct credit substitute. Direct credit substitutes include, but are not limited to:

(i) Financial standby letters of credit, which includes any letter of credit or similar arrangement, however named or described, that support financial claims on a third party that exceeds a bank's pro rata share of losses in the financial claim;

(ii) Guarantees, surety arrangements, credit derivatives, and similar instruments backing financial claims;

(iii) Purchased subordinated interests or securities that absorb more than their pro rata share of credit losses from the underlying assets;

(iv) Credit derivative contracts under which the bank assumes more than its pro rata share of credit risk on a third party asset or exposure;

(iv) Entering into a credit derivative contract under which the bank assumes more than its pro rata share of credit risk on a third-party asset or exposure;

(v) Loans or lines of credit that provide credit enhancement for the financial obligations of an account party;

(vi) Purchased loan servicing assets if the servicer;

(A) Is responsible for credit losses associated with the loans being serviced;

(B) Is responsible for making mortgage servicer cash advances (unless the advances are not direct credit substitutes because they meet the conditions specified in II.B.5 (a)(9) of this appendix E), or

(C) Makes or assumes credit-enhancing representations and warranties with respect to the loans serviced;

(vii) Clean-up calls on third party assets. Clean-up calls that are exercisable at the option of the bank (as servicer or as an affiliate of the servicer) when the pool balance is 10 percent or less of the original pool balance are not direct credit substitutes; and

(5) <u>Eligible ABCP liquidity facility</u> means a liquidity facility supporting ABCP, in form or in substance, that is subject to an asset quality test at the time of draw that precludes funding against assets that are 90 days or more past due or in default. In addition, if the assets that an eligible ABCP liquidity facility is required to fund against are externally rated assets or exposures at the inception of the facility, the facility can be used to fund only those assets or exposures that are externally rated investment grade at the time of funding. Notwithstanding the eligibility requirements set forth in the two preceding sentences, a liquidity facility will be considered an eligible ABCP liquidity facility if the assets that are funded under the liquidity facility and which do not meet the eligibility requirements are guaranteed, either conditionally or unconditionally, by the U.S. government or its agencies, or by the central government of an OECD country.

(6) <u>External rating</u> is defined above in the definitions to appendix E.

(7) <u>Face amount</u> means the notional principal, or face value, amount of an off-balance sheet item; the amortized cost of an asset not held for trading purposes; and the fair value of a trading asset.

(8) <u>Financial asset</u> means cash or other monetary instrument, evidence of debt, evidence of an ownership interest in an entity, or a contract that conveys a right to receive or exchange cash or another financial instrument from another party.

(9) Financial standby letter of credit means a letter of credit or similar arrangement that represents an irrevocable obligation to a third-party beneficiary:

(i) To receive money borrowed by, or advanced to, or for the account of, a second party (the account party), or

(ii) To make payment on behalf of the account party, in the event that the account party fails to fulfill its obligation to the beneficiary.

(10) Liquidity facility means a legally binding commitment to provide liquidity support to ABCP by lending to, or purchasing assets from, any structure, program, or conduit in the event that funds are required to repay maturing ABCP.

(11) Mortgage servicer cash advance means funds that a residential mortgage servicer advances to ensure an uninterrupted flow of payments, including advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the loan. A mortgage servicer cash advance is not a recourse obligation or a direct credit substitute if:

(i) The mortgage servicer is entitled to full reimbursement and this right is not subordinated to other claims on the cash flows from the underlying asset pool; or

(ii) For any one loan, the servicer's obligation to make nonreimbursable advances is contractually limited to an insignificant amount of the outstanding principal of that loan.

(12) Nationally recognized statistical rating organization (NRSRO) means an entity recognized by the Division of Market Regulation of the Securities and Exchange Commission (or any successor Division) (Commission) as a nationally recognized statistical rating organization for various purposes, including the Commission's uniform net capital requirements for brokers and dealers (17 CFR 240.15c3--1).

(13) <u>Recourse</u> means an arrangement in which a bank retains, in form or in substance, of any credit risk directly or indirectly associated with an asset it has sold (in accordance with generally accepted accounting principles) that exceeds a pro rata share of the bank's claim on the asset. If a bank has no claim on an asset it has sold, then the retention of any credit risk is recourse. A recourse obligation typically arises when an institution transfers assets in a sale and retains an obligation to repurchase the assets or absorb losses due to a default of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may exist implicitly where a bank provides credit enhancement beyond any contractual obligation to support assets it has sold. The following are examples of recourse arrangements:

(i) Credit-enhancing representations and warranties made on the transferred assets;

(ii) Loan servicing assets retained pursuant to an agreement under which the bank:

(A) Is responsible for losses associated with the loans being serviced, or

(B) Is responsible for making mortgage servicer cash advances (unless the advances are not a recourse obligation because they meet the conditions specified in section II.B.5(a)(11) of this appendix E).

(iii) Retained subordinated interests that absorb more than their pro rata share of losses from the underlying assets;

(iv) Assets sold under an agreement to repurchase, if the assets are not already included on the balance sheet;

(v) Loan strips sold without contractual recourse where the maturity of the transferred portion of the loan is shorter than the maturity of the commitment under which the loan is drawn;

(vi) Credit derivative contracts under which the bank retains more than its pro rata share of credit risk on transferred assets;

(vii) Clean-up calls at inception that are greater than 10 percent of the balance of the original pool of transferred loans. Clean-up calls that are 10 percent or less of the original pool balance that are exercisable at the option of the bank are not recourse arrangements; and

(viii) Liquidity facilities that provide liquidity support to ABCP (other than eligible ABCP liquidity facilities).

(14) Residual interest means any on-balance sheet asset that represents an interest (including a beneficial interest) created by a transfer that qualifies as a sale (in accordance with generally accepted accounting principles (GAAP)) of financial assets, whether through a securitization or otherwise, and that exposes a bank to credit risk directly or indirectly associated with the transferred assets that exceeds a pro rata share of the bank's claim on the assets, whether through subordination provisions or other credit enhancement techniques. Residual interests generally include credit-enhancing I/Os, spread accounts, cash collateral accounts, retained subordinated interests, other forms of over-collateralization, and similar assets that function as a credit enhancement. Residual interests further include those exposures that, in substance, cause the bank to retain the credit risk of an asset or exposure that had qualified as a residual interest before it was sold. Residual interests generally do not include interests purchased from a third party, except that purchased credit-enhancing I/Os are residual interests for purposes of the risk-based capital treatment in this appendix.

(15) Risk participation means a participation in which the originating party remains liable to the beneficiary for the full amount of an obligation (e.g., a direct credit substitute) notwithstanding that another party has acquired a participation in that obligation.

(16) Securitization means the pooling and repackaging by a special purpose entity of assets or other credit exposures into securities that can be sold to investors. Securitization includes

transactions that create stratified credit risk positions whose performance is dependent upon an underlying pool of credit exposures, including loans and commitments.

(17) Sponsor means a bank that establishes an ABCP program; approves the sellers permitted to participate in the program; approves the asset pools to be purchased by the program; or administers the ABCP program by monitoring the assets, arranging for debt placement, compiling monthly reports, or ensuring compliance with the program documents and with the program's credit and investment policy.

(18) Structured finance program means a program where receivable interests and asset-backed securities issued by multiple participants are purchased by a special purpose entity that repackages those exposures into securities that can be sold to investors. Structured finance programs allocate credit risks, generally, between the participants and credit enhancement provided to the program.

(19) Traded position means a position that has an external rating and is retained, assumed or issued in connection with an asset securitization, where there is a reasonable expectation that, in the near future, the rating will be relied upon by unaffiliated investors to purchase the position; or an unaffiliated third party to enter into a transaction involving the position, such as a purchase, loan, or repurchase agreement.

(b) Credit equivalent amounts and risk weights of recourse obligations and direct credit substitutes--(1) General rule for determining the credit-equivalent amount. Except as otherwise provided, the credit-equivalent amount for a recourse obligation or direct credit substitute is the full amount of the credit-enhanced assets for which the bank directly or indirectly retains or assumes credit risk multiplied by a 100% conversion factor. Thus, a bank that extends a partial direct credit substitute, e.g., a financial standby letter of credit that absorbs the first 10 percent of loss on a transaction, must maintain capital against the full amount of the assets being supported.

(2) Risk-weight factor. To determine the bank's risk-weighted assets for an off-balance sheet recourse obligation or a direct credit substitute, the credit equivalent amount is assigned to the risk category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral. For a direct credit substitute that is an on-balance sheet asset, e.g., a purchased subordinated security, a bank must calculate risk-weighted assets using the amount of the direct credit substitute and the full amount of the assets it supports, i.e., all the more senior positions in the structure. The treatment covered in this paragraph (b) is subject to the low-level exposure rule provided in section II.B.5(h)(1) of this appendix E.

<u>(c) Credit equivalent amount and risk weight of participations in, and syndications of, direct credit substitutes</u>. Subject to the low-level exposure rule provided in section II.B.5(h)(1) of this appendix E, the credit equivalent amount for a participation interest in, or syndication of, a direct credit substitute (excluding purchased credit-enhancing interest-only strips) is calculated and risk weighted as follows:

(1) Treatment for direct credit substitutes for which a bank has conveyed a risk participation. In the case of a direct credit substitute in which a bank has conveyed a risk participation, the full amount of the assets that are supported by the direct credit substitute is converted to a credit equivalent amount using a 100% conversion factor. However, the pro rata share of the credit equivalent amount that has been conveyed through a risk participation is then assigned to whichever risk-weight category is lower: the risk-weight category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral, or the risk-weight category appropriate to the party acquiring the participation. The pro rata share of the

credit equivalent amount that has not been participated out is assigned to the risk-weight category appropriate to the obligor guarantor, or collateral. For example, the pro rata share of the full amount of the assets supported, in whole or in part, by a direct credit substitute conveyed as a risk participation to a U.S. domestic depository institution or an OECD bank is assigned to the 20 percent risk category. [59]

(2) Treatment for direct credit substitutes in which the bank has acquired a risk participation. In the case of a direct credit substitute in which the bank has acquired a risk participation, the acquiring bank's pro rata share of the direct credit substitute is multiplied by the full amount of the assets that are supported by the direct credit substitute and converted using a 100% credit conversion factor. The resulting credit equivalent amount is then assigned to the risk-weight category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral.

(3) Treatment for direct credit substitutes related to syndications. In the case of a direct credit substitute that takes the form of a syndication where each party is obligated only for its pro rata share of the risk and there is no recourse to the originating entity, each bank's credit equivalent amount will be calculated by multiplying only its pro rata share of the assets supported by the direct credit substitute by a 100% conversion factor. The resulting credit equivalent amount is then assigned to the risk-weight category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral.

(d) Positions with external ratings: credit-equivalent amounts and risk weights.--(1) Traded positions. With respect to a recourse obligation, direct credit substitute, residual interest (other than a credit-enhancing interest-only strip) or mortgage- or asset-backed security that is a

[59] A risk participation with a remaining maturity of one year or less that is conveyed to a non-OECD bank is also assigned to the 20 percent risk category.

"traded position" and that has received an external rating on a long-term position that is one grade below investment grade or better or a short-term position that is investment grade, the bank may multiply the face amount of the position by the appropriate risk weight, determined in accordance with Table A or B of this appendix E, as appropriate. [60] If a traded position receives more than one external rating, the lowest rating will apply and that external rating must apply to the claim or exposure in its entirety. Thus, for banks that hold split or partially-rated instruments, the risk weight that corresponds to the lowest component rating will apply to the entire exposure. For example, a purchased subordinated security where the principal component is rated BBB, but the interest component is rated B, will be subject to the gross-up treatment accorded to residual interests rated B or lower. Similarly, if a portion of an instrument is unrated, the entire position will be treated as if it were unrated.

The FDIC reserves the authority to override the use of certain ratings or the ratings on certain instruments, either on a case-by-case basis or through broader supervisory policy, if necessary or appropriate to address the risk that an instrument poses to a bank.

Table A: Risk Weights for Long-term External Ratings of Securitization Exposures

Long-term rating category	**Examples**	**Risk Weight**
Highest investment grade rating	AAA	20 percent
Second-highest investment grade rating	AA	20 percent
Third-highest investment grade rating	A	35 percent
Lowest-investment grade rating – plus	BBB+	50 percent
Lowest-investment grade rating – naught	BBB	75 percent
Lowest-investment grade rating – negative	BBB-	100 percent
One category below investment grade – plus & naught	BB+, BB	200 percent
One category below investment grade - negative	BB-	200 percent

[60] Stripped mortgage-backed securities and similar instruments, such as interest-only strips that are not credit-enhancing and principal-only strips, must be assigned to the 100% risk category.

Two or more categories below investment grade	B, CCC	Dollar for Dollar
Unrated	n/a	Dollar for Dollar

Table B: Risk Weights For Short-Term External Ratings of Securitization Exposures

Short-term rating category	Examples	Risk Weight
Highest investment grade rating *	A-1, P-1	20 percent
Second-highest investment grade rating	A-2, P-2	35 percent
Lowest investment grade rating	A-3, P-3	75 percent
Unrated	n/a	

(2) Non-traded positions. A recourse obligation, direct credit substitute, residual interest (but not a credit-enhancing interest-only strip) or mortgage- or asset-backed security extended in connection with a securitization that is not a "traded position" may be assigned a risk weight in accordance with section II.B.5(d)(1) of this appendix E if:

(i) It has been externally rated by more than one NRSRO;

(ii) It has received an external rating on a long-term position that is one category below investment grade or better or a short-term position that is investment grade by all NRSROs providing a rating;

(iii) The ratings are publicly available; and

(iv) The ratings are based on the same criteria used to rate traded positions. If the ratings are different, the lowest rating will determine the risk category to which the recourse obligation, direct credit substitute, residual interest, or mortgage- or asset-backed security will be assigned.

(e) Senior positions not externally rated. For a recourse obligation, direct credit substitute, residual interest or mortgage- or asset-backed security that is not externally rated but is senior in all features to a traded position (including collateralization and maturity), a bank may apply a risk weight to the face amount of the senior position in accordance with section II.B.5(d)(1) of this appendix E, based upon the risk weight of the traded position, subject to any current or prospective supervisory guidance and the bank satisfying the FDIC that this treatment is appropriate. This section will apply only if the traded position provides substantial credit support for the entire life of the unrated position.

(f) Residual interests--(1) Concentration limit on credit-enhancing interest-only strips. In addition to the capital requirement provided by section II.B.5(f)(2) of this appendix E, a bank must deduct from Tier 1 capital the face amount of all credit-enhancing interest-only strips in excess of 25 percent of Tier 1 capital in accordance with § 325.5(f)(3).

(2) Credit-enhancing interest-only strip capital requirement. After applying the concentration limit to credit-enhancing interest-only strips in accordance with § 325.5(f)(3), a bank must maintain risk-based capital for a credit-enhancing interest-only strip, equal to the remaining face amount of the credit-enhancing interest-only strip (net of the remaining proportional amount of any existing associated deferred tax liability recorded on the balance sheet), even if the amount if risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. Transactions that, in substance, result in the retention of credit risk associated with a transferred credit-enhancing interest-only strip will be treated as if the credit-enhancing interest-only strip was retained by the bank and not transferred.

(3) Other residual interests capital requirement. Except as otherwise provided in section II.B.5(d) or (e) of this appendix E, a bank must maintain risk-based capital for a residual interest (excluding a credit-enhancing interest-only strip) equal to the face amount of the residual interest (net of any existing associated deferred tax liability recorded on the balance sheet), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital

requirement for the assets transferred. Transactions that, in substance, result in the retention of credit risk associated with a transferred residual interest will be treated as if the residual interest was retained by the bank and not transferred.

(4) Residual interests and other recourse obligations. Where the aggregate capital requirement for residual interests (including credit-enhancing interest-only strips) and recourse obligations arising from the same transfer of assets exceed the full risk-based capital requirement for assets transferred, a bank must maintain risk-based capital equal to the greater of the risk-based capital requirement for the residual interest as calculated under sections II.B.5(f)(2) through (3) of this appendix E or the full risk-based capital requirement for the assets transferred.

(g) Positions that are not rated by an NRSRO. A bank's position (other than a residual interest) in a securitization or structured finance program that is not rated by an NRSRO may be risk-weighted based on the bank's determination of the credit rating of the position, as specified in Table C of this appendix E, multiplied by the face amount of the position. In order to qualify for this treatment, the bank's system for determining the credit rating of the position must meet one of the three alternative standards set out in section II.B.5(g)(1) through (3) of this appendix E.

Table C

Rating category	**Examples**	**Risk Weight**
Investment grade	BBB or other	100 percent
One category below investment grade	BB	200 percent

(1) Internal risk rating used for asset-backed programs. A bank extends a direct credit substitute (but not a purchased credit-enhancing interest-only strip) to an asset-backed commercial paper program sponsored by the bank and the bank is able to demonstrate to the

satisfaction of the FDIC, prior to relying upon its use, that the bank's internal credit risk rating system is adequate. Adequate internal credit risk rating systems usually contain the following criteria: [61]

(i) The internal credit risk rating system is an integral part of the bank's risk management system that explicitly incorporates the full range of risks arising form a bank's participation in securitization activities;

(ii) Internal credit ratings are linked to measurable outcomes, such as the probability that the position will experience any loss, the position's expected loss given default, and the degree of variance in losses given default on that position;

(iii) The internal credit risk rating system must separately consider the risk associated with the underlying loans or borrowers, and the risk associated with the structure of a particular securitization transaction;

(iv) The internal credit risk rating system identifies gradations of risk among "pass" assets and other risk positions;

(v) The internal credit risk rating system must have clear, explicit criteria (including for subjective factors), that are used to classify assets into each internal risk grade;

(vi) The bank must have independent credit risk management or loan review personnel assigning or reviewing the credit risk ratings;

(vii) An internal audit procedure should periodically verify that internal risk ratings are assigned in accordance with the bank's established criteria;

(viii) The bank must monitor the performance of the internal credit risk ratings assigned to nonrated, nontraded direct credit substitutes over time to determine the appropriateness of the

[61] The adequacy of a bank's use of its internal credit risk rating system must be demonstrated to the FDIC considering the criteria listed in this section and the size and complexity of the credit exposures assumed by the bank.

initial credit risk rating assignment and adjust individual credit risk ratings, or the overall internal credit risk ratings system, as needed; and

(ix) The internal credit risk rating system must make credit risk rating assumptions that are consistent with, or more conservative than, the credit risk rating assumptions and methodologies of NRSROs.

(2) Program Ratings. A bank extends a direct credit substitute or retains a recourse obligation (but not a residual interest) in connection with a structured finance program and an NRSRO has reviewed the terms of the program and stated a rating for positions associated with the program. If the program has options for different combinations of assets, standards, internal credit enhancements and other relevant factors, and the NRSRO specified ranges of rating categories to them, the bank may apply the rating category applicable to the option that corresponds to the bank's position. In order to rely on a program rating, the bank must demonstrate to the FDIC's satisfaction that the credit risk rating assigned to the program meets the same standards generally used by NRSROs for rating traded positions. The bank must also demonstrate to the FDIC's satisfaction that the criteria underlying the NRSRO's assignment of ratings for the program are satisfied for the particular position issued by the bank. If a bank participates in a securitization sponsored by another party, the FDIC may authorize the bank to use this approach based on a program rating obtained by the sponsor of the program.

(3) Computer Program. A bank is using an acceptable credit assessment computer program that has been developed by an NRSRO to determine the rating of a direct credit substitute or recourse obligation (but not a residual interest) extended in connection with a structured finance program. In order to rely on the rating determined by the computer program, the bank must demonstrate to the FDIC's satisfaction that ratings under the program correspond credibly and reliably with the

ratings of traded positions. The bank must also demonstrate to the FDIC's satisfaction the credibility of the program in financial markets, the reliability of the program in assessing credit risk, the applicability of the program to the bank's position, and the proper implementation of the program.

(h) Limitations on risk-based capital requirements--(1) Low-level exposure rule. If the maximum exposure to loss retained or assumed by a bank in connection with a recourse obligation, a direct credit substitute, or a residual interest is less than the effective risk-based capital requirement for the credit-enhanced assets, the risk-based capital required under this appendix E is limited to the bank's maximum contractual exposure, less any recourse liability account established in accordance with generally accepted accounting principles. This limitation does not apply when a bank provides credit enhancement beyond any contractual obligation to support assets it has sold.

(2) Mortgage-related securities or participation certificates retained in a mortgage loan swap. If a bank holds a mortgage-related security or a participation certificate as a result of a mortgage loan swap with recourse, capital is required to support the recourse obligation plus the percentage of the mortgage-related security or participation certificate that is not covered by the recourse obligation. The total amount of capital required for the on-balance sheet asset and the recourse obligation, however, is limited to the capital requirement for the underlying loans, calculated as if the bank continued to hold these loans as an on-balance sheet asset.

(3) Related on-balance sheet assets. If a recourse obligation or direct credit substitute also appears as a balance sheet asset, the asset is risk-weighted only under this section II.B.5 of this appendix E, except in the case of loan servicing assets and similar arrangements with embedded recourse obligations or direct credit substitutes. In that case, the on-balance sheet servicing assets

and the related recourse obligations or direct credit substitutes must both be separately risk weighted and incorporated into the risk-based capital calculation.

(i) Alternative Capital Calculation for Small Business Obligations.

(1) Definitions. For purposes of this section II.B.5(i);

(i) Qualified bank means a bank that:

(A) Is well capitalized as defined in § 325.103(b)(1) without applying the capital treatment described in this section II.B.5(i), or

(B) Is adequately capitalized as defined in § 325.103(b)(2) without applying the capital treatment described in this section II.B.5(i) and has received written permission by order of the FDIC to apply the capital treatment described in this section II.B.5(i).

(iii) Small business means a business that meets the criteria for a small business concern established by the Small Business Administration in 13 CFR part 121 pursuant to 15 U.S.C. 632.

(2) Capital and reserve requirements. Notwithstanding the risk-based capital treatment outlined in any other paragraph (other than paragraph (i) of this section II.B.5), with respect to a transfer with recourse of a small business loan or a lease to a small business of personal property that is a sale under generally accepted accounting principles, and for which the bank establishes and maintains a non-capital reserve under generally accepted accounting principles sufficient to meet the reasonable estimated liability of the bank under the recourse arrangement; a qualified bank may elect to include only the face amount of its recourse in its risk-weighted assets for purposes of calculating the bank's risk-based capital ratio.

(3) Limit on aggregate amount of recourse. The total outstanding amount of recourse retained by a qualified bank with respect to transfers of small business loans and leases to small businesses of personal property and included in the risk-weighted assets of the bank as described

in section II.B.5(i)(2) of this appendix E may not exceed 15 percent of the bank's total risk-based capital, unless the FDIC specifies a greater amount by order.

(4) Bank that ceases to be qualified or that exceeds aggregate limit. If a bank ceases to be a qualified bank or exceeds the aggregate limit in section II.B.5(i)(3) of this appendix E, the bank may continue to apply the capital treatment described in section II.B.5(i)(2) of this appendix E to transfers of small business loans and leases to small businesses of personal property that occurred when the bank was qualified and did not exceed the limit.

(5) Prompt correction action not affected. (i) A bank shall compute its capital without regard to this section II.B.5(i) for purposes of prompt corrective action (12 U.S.C. 1831o) unless the bank is a well capitalized bank (without applying the capital treatment described in this section II.B.5(i)) and, after applying the capital treatment described in this section II.B.5(i), the bank would be well capitalized.

(ii) A bank shall compute its capital without regard to this section II.B.5(i) for purposes of 12 U.S.C. 1831o(g) regardless of the bank's capital level.

(6) Nonfinancial equity investments. (i) General. A bank must deduct from its Tier 1 capital the sum of the appropriate percentage (as determined below) of the adjusted carrying value of all nonfinancial equity investments held by the bank or by its direct or indirect subsidiaries. For purposes of this section II.B.(6), investments held by a bank include all investments held directly or indirectly by the bank or any of its subsidiaries.

(ii) Scope of nonfinancial equity investments. A nonfinancial equity investment means any equity investment held by the bank in a nonfinancial company: through a small business investment company (SBIC) under section 302(b) of the Small Business Investment Act of 1958

(15 U.S.C. 682(b)); [62] under the portfolio investment provisions of Regulation K issued by the Board of Governors of the Federal Reserve System (12 CFR 211.8(c)(3)); or under section 24 of the Federal Deposit Insurance Act (12 U.S.C. 1831a), other than an investment held in accordance with section 24(f) of that Act. [63] A nonfinancial company is an entity that engages in any activity that has not been determined to be permissible for the bank to conduct directly, or to be financial in nature or incidental to financial activities under section 4(k) of the Bank Holding Company Act (12 U.S.C. 1843(k)).

(iii) Amount of deduction from core capital. (A) The bank must deduct from its Tier 1 capital the sum of the appropriate percentages, as set forth in the table following this paragraph, of the adjusted carrying value of all nonfinancial equity investments held by the bank. The amount of the percentage deduction increases as the aggregate amount of nonfinancial equity investments held by the bank increases as a percentage of the bank's Tier 1 capital.

Deduction for Nonfinancial Equity Investments

Aggregate adjusted carrying value of all nonfinancial equity investments held directly or indirectly by the bank (as a percentage of the Tier 1 capital of the bank)[1]	Deduction from Tier 1 Capital (as a percent-age of the adjusted carrying value of the investment)
Less than 15 percent	8 percent.
15 percent to 24.99 percent	12 percent.
25 percent and above	25 percent.

[1]For purposes of calculating the adjusted carrying value of nonfinancial equity investments as a

[62] An equity investment made under section 302(b) of the Small Business Investment Act of 1958 in a SBIC that is not consolidated with the bank is treated as a nonfinancial equity investment.

[63] The Board of Directors of the FDIC, acting directly, may, in exceptional cases and after a review of the proposed activity, permit a lower capital deduction for investments approved by the Board of Directors under section 24 of the FDI Act so long as the bank's investments under section 24 and SBIC investments represent, in the aggregate, less than 15 percent of the Tier 1 capital of the bank. The FDIC reserves the authority to impose higher capital charges on any investment where appropriate.

percentage of Tier 1 capital. Tier 1 capital is defined as the sum of core capital elements net of goodwill and net of all identifiable intangible assets other than mortgage servicing assets, non-mortgage servicing assets and purchased credit card relationships, but prior to the deduction for any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit-enhancing interest-only strips (both purchased and retained), any disallowed deferred tax assets, and any nonfinancial equity investments.

(B) These deductions are applied on a marginal basis to the portions of the adjusted carrying value of nonfinancial equity investments that fall within the specified ranges of the parent bank's Tier 1 capital. For example, if the adjusted carrying value of all nonfinancial equity investments held by a bank equals 20 percent of the Tier 1 capital of the bank, then the amount of the deduction would be 8 percent of the adjusted carrying value of all investments up to 15 percent of the bank's Tier capital, and 12 percent of the adjusted carrying value of all investments in excess of 15 percent of the bank's Tier 1 capital.

(C) The total adjusted carrying value of any nonfinancial equity investment that is subject to deduction under this paragraph is excluded from the bank's risk-weighted assets for purposes of computing the denominator of the bank's risk-based capital ratio and from total assets for purposes of calculating the denominator of the leverage ratio. [64]

(D) This appendix E establishes minimum risk-based capital ratios and banks are at all times expected to maintain capital commensurate with the level and nature of the risks to which they are exposed. The risk to a bank from nonfinancial equity investments increases with its concentration in such investments and strong capital levels above the minimum requirements are

[64] For example, if 8 percent of the adjusted carrying value of a nonfinancial equity investment is deducted from Tier 1 capital, the entire adjusted carrying value of the investment will be excluded from both risk-weighted assets and total assets in calculating the respective denominators for the risk-based capital and leverage ratios

particularly important when a bank has a high degree of concentration in nonfinancial equity investments (e.g., in excess of 50 percent of Tier 1 capital). The FDIC intends to monitor banks and apply heightened supervision to equity investment activities as appropriate, including where the bank has a high degree of concentration in nonfinancial equity investments, to ensure that each bank maintains capital levels that are appropriate in light of its equity investment activities. The FDIC also reserves authority to impose a higher capital charge in any case where the circumstances, such as the level of risk of the particular investment or portfolio of investments, the risk management systems of the bank, or other information, indicate that a higher minimum capital requirement is appropriate.

(iv) SBIC investments. (A) No deduction is required for nonfinancial equity investments that are held by a bank through one or more SBICs that are consolidated with the bank or in one or more SBICs that are not consolidated with the bank to the extent that all such investments, in the aggregate, do no exceed 15 percent of the bank's Tier 1 capital. Any nonfinancial equity investment that is held through an SBIC or in an SBIC and that is not required to be deducted from Tier 1 capital under this section II.B.(6)(iv) will be assigned a 100 percent risk-weight and included in the bank's consolidated risk-weighted assets. [65]

(B) To the extent the adjusted carrying value of all nonfinancial equity investments that a bank holds through one or more SBICs that are consolidated with the bank or in one or more

[65] If a bank has an investment in a SBIC that is consolidated for accounting purposes but that is not wholly owned by the bank, the adjusted carrying value of the bank's nonfinancial equity investments through the SBIC is equal to the bank's proportionate share of the adjusted carrying value of the SBIC's investments in nonfinancial companies. The remainder of the SBIC's adjusted carrying value (i.e., the minority interest holders' proportionate share) is excluded from the risk-weighted assets of the bank. If a bank has an investment in a SBIC that is not consolidated for accounting purposes and has current information that identifies the percentage of the SBIC's assets that are equity investments in nonfinancial companies, the bank may reduce the adjusted carrying value of its investment in the SBIC proportionately to reflect the percentage of the adjusted carrying value of the SBIC's assets that are not equity investments in nonfinancial companies. If a bank reduces the adjusted carrying value of its investment in a non-consolidated SBIC to reflect financial investments of the SBIC, the amount of the adjustment will be risk weighted at 100 percent and included in the bank's risk-weighted assets.

SBICs that are not consolidated with the bank exceeds, in the aggregate, 15 percent of the bank's Tier 1 capital, the appropriate percentage of such amounts (as set forth in the table in section II.B.(6)(iii)(A)) must be deducted from the bank's common stockholders' equity in determining the bank's Tier 1 capital. In addition, the aggregate adjusted carrying value of all nonfinancial equity investments held by a bank through a consolidated SBIC and in a non-consolidated SBIC (including any investments for which no deduction is required) must be included in determining, for purposes of the table in section II.B.(6)(iii)(A), the total amount of nonfinancial equity investments held by the bank in relation to its Tier 1 capital.

(v) Transition provisions. No deduction under this section II.B.(6) is required to be made with respect to the adjusted carrying value of any nonfinancial equity investment (or portion of such an investment) that was made by the bank prior to March 13, 2000, or that was made by the bank after such date pursuant to a binding written commitment [66] entered into prior to March 13, 2000, provided that in either case the bank has continuously held the investment since the relevant investment date. [67] For purposes of this section II.B.(6)(v) a nonfinancial equity investment made prior to March 13, 2000, includes any shares or other interests received by the bank through a stock split or stock dividend on an investment made prior to March 13, 2000, provided the bank provides no consideration for the shares or interests received and the

[66] A "binding written commitment" means a legally binding written agreement that requires the bank to acquire shares or other equity of the company, or make a capital contribution to the company, under terms and conditions set forth in the agreement. Options, warrants, and other agreements that give a bank the right to acquire equity or make an investment, but do not require the bank to take such actions, are not considered a binding written commitment for purposes of this section II.B.(6)(v).

[67] For example, if a bank made an equity investment in 100 shares of a nonfinancial company prior to March 13, 2000, the adjusted carrying value of that investment would not be subject to a deduction under this section II.B.(6). However, if the bank made any additional equity investment in the company after March 13, 2000, such as by purchasing additional shares of the company (including through the exercise of options or warrants acquired before or after March 13, 2000) or by making a capital contribution to the company and such investment was not made pursuant to a binding written commitment entered into before March 13, 2000, the adjusted carrying value of the additional investment would be subject to a deduction under this section II.B.(6). In addition, if the bank sold and repurchased, after March 13, 2000, 40 shares of the company, the adjusted carrying value of those 40 shares would be subject to a deduction under this section II.B.(6).

transaction does not materially increase the bank's proportional interest in the company. The exercise on or after March 13, 2000, of options or warrants acquired prior to March 13, 2000, is not considered to be an investment made prior to March 13, 2000, if the bank provides any consideration for the shares or interests received upon exercise of the options or warrants. Any nonfinancial equity investment (or portion thereof) that is not required to be deducted from Tier 1 capital under this section II.B.(6)(v) must be included in determining the total amount of nonfinancial equity investments held by the bank in relation to its Tier 1 capital for purposes of the table in section II.B.(6)(iii)(A). In addition, any nonfinancial equity investment (or portion thereof) that is not required to be deducted from Tier 1 capital under this section II.B.(6)(v) will be assigned a 100-percent risk weight and included in the bank's consolidated risk-weighted assets.

(vi) Adjusted carrying value. (A) For purposes of this section II.B.(6), the "adjusted carrying value" of investments is the aggregate value at which the investments are carried on the balance sheet of the bank reduced by any unrealized gains on those investments that are reflected in such carrying value but excluded from the bank's Tier 1 capital and associated deferred tax liabilities. For example, for equity investments held as available-for-sale (AFS), the adjusted carrying value of the investments would be the aggregate carrying value of those investments (as reflected on the consolidated balance sheet of the bank) less any unrealized gains on those investments that are included in other comprehensive income and not reflected in Tier 1 capital, and associated deferred tax liabilities. [68]

(B) As discussed above with respect to consolidated SBICs, some equity investments may be in companies that are consolidated for accounting purposes. For investments in a nonfinancial

[68] Unrealized gains on available-for-sale equity investments may be included in Tier 2 capital to the extent permitted under section I.A.(2)(f) of this appendix E. In addition, the net unrealized losses on available-for-sale equity investments are deducted from Tier 1 capital in accordance with section I.A.(1) of this appendix E.

company that is consolidated for accounting purposes under generally accepted accounting principles, the bank's adjusted carrying value of the investment is determined under the equity method of accounting (net of any intangibles associated with the investment that are deducted from the bank's core capital in accordance with section I.A.(1) of this appendix E). Even though the assets of the nonfinancial company are consolidated for accounting purposes, these assets (as well as the credit equivalent amounts of the company's off-balance sheet items) should be excluded from the bank's risk-weighted assets for regulatory capital purposes.

(vii) Equity investments. For purposes of this section II.B.(6), an equity investment means any equity instrument (including common stock, preferred stock, partnership interests, interests in limited liability companies, trust certificates and warrants and call options that give the holder the right to purchase an equity instrument), any equity feature of a debt instrument (such as a warrant or call option), and any debt instrument that is convertible into equity where the instrument or feature is held under one of the legal authorities listed in section II.B.(6)(ii) of this appendix E. An investment in any other instrument (including subordinated debt) may be treated as an equity investment if, in the judgment of the FDIC, the instrument is the functional equivalent of equity or exposes the bank to essentially the same risks as an equity instrument.

(b) For purposes of this appendix E, a qualifying institution is a bank that is well capitalized. In addition, by order of the FDIC, a bank that is adequately capitalized may be deemed a qualifying institution. In determining whether a bank meets the qualifying institution criteria, the prompt corrective action well capitalized and adequately capitalized definitions set forth in § 325.103 shall be used, except that the bank's capital ratios must be calculated without regard to the preferential capital treatment for transfers of small business obligations with recourse specified in section II.B.6.(a) of this appendix E. The total outstanding amount of recourse retained by a qualifying institution on transfers of small business obligations receiving the preferential capital treatment cannot exceed 15 percent of the institution's total risk-based capital. By order, the FDIC may approve a higher limit.

(c) If a bank ceases to be a qualifying institution or exceeds the 15 percent of capital limit under section II.B.6.(b) of this appendix E, the preferential capital treatment will continue to apply to any transfers of small business obligations with recourse that were consummated during the time the bank was a qualifying institution and did not exceed such limit.

(d) The risk-based capital ratios of a bank shall be calculated without regard to the preferential capital treatment for transfers of small business obligations with recourse specified in paragraph (a) of this section for purposes of:

(i) Determining whether a bank is adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized under the prompt corrective action capital category definitions specified in § 325.103; and

(ii) Applying the prompt corrective action reclassification provisions specified in § 325.103(d), regardless of the bank's capital level.

6. Asset-backed commercial paper programs. a. An asset-backed commercial paper (ABCP) program means a program that primarily issues externally rated commercial paper backed by assets or other exposures held in a bankruptcy-remote, special purpose entity.

b. A bank that qualifies as a primary beneficiary and must consolidate an ABCP program that is defined as a variable interest entity under GAAP may exclude the consolidated ABCP program assets from risk-weighted assets provided that the bank is the sponsor of the ABCP program. If a bank excludes such consolidated ABCP program assets, the bank must assess the appropriate risk-based capital charge against any exposures of the bank arising in connection with such

ABCP programs, including direct credit substitutes, recourse obligations, residual interests, liquidity facilities, and loans, in accordance with sections II.B.5, II.C. and II.D. of this appendix E.

c. If a bank has multiple overlapping exposures (such as a program-wide credit enhancement and multiple pool-specific liquidity facilities) to an ABCP program that is not consolidated for risk-based capital purposes, the bank is not required to hold capital under duplicative risk-based capital requirements under this appendix E against the overlapping position. Instead, the bank should apply to the overlapping position the applicable risk-based capital treatment that results in the highest capital charge.

7. <u>Securitizations of revolving credit with early amortization provisions.</u>

<u>a. Definitions.</u> For purposes of this section II.B.7, the following definitions will apply:

(1) <u>Early amortization provision</u> means a provision in the documentation governing a securitization that, when triggered, causes investors in the securitization exposures to be repaid before the original stated maturity of the securitization exposures, unless the provision is triggered solely by events not directly related to the performance of the underlying exposures or the originating bank (such as material changes in tax laws or regulations).

(2) <u>Excess spread</u> means gross finance charge collections and other income received by a trust or special purpose entity minus interest paid to the investors in the securitization exposures, servicing fees, charge-offs, and other similar trust or special purpose entity expenses.

(3) <u>Excess spread trapping point</u> means the point at which the bank is required by the documentation governing a securitization to divert and hold excess spread in a spread or reserve account, expressed as a percent.

(4) <u>Investors' interest</u> is the total securitization exposure represented by securities issued by a trust or special purpose entity to investors.

(5) <u>Revolving Credit</u> means a line of credit where the borrower is permitted to vary both the drawn amount and the amount of repayment within an agreed limit.

<u>b. Capital charge for revolving securitizations with an early amortizations trigger.</u> A bank that securitizes revolving credits where the securitization structure contains an early amortization provision must maintain risk-based capital against the investors' interest as required under this section.

<u>c. Calculation.</u> Capital for securitizations of revolving credit exposures that incorporate early-amortization provisions will be assessed based on a comparison of the securitizations' three-month average excess spread against the excess spread trapping point.

(1) To calculate the securitization's excess spread trapping point ratio, a bank must first calculate the three-month average of:

A. the dollar amount of excess spread divided by

B. the outstanding principal balance of the underlying pool of exposures at the end of each of the prior three months.

(2) This annualized three-month average of excess spread is then divided by the excess spread trapping point that is required by the securitization structure.

(3) The excess spread trapping point ratio is compared to the ratios contained in Table EA to determine the appropriate conversion factor to apply to the investors' interest.

(4) The amount of investors' interest after conversion is then assigned capital based on the underlying obligor, collateral, or guarantor.

d. Default for certain securitizations. For purposes of section II.B.7 of this appendix E, for securitizations that do not require excess spread to be trapped, or that specify the trapping points based primarily on the performance measures other than the three-month average excess spread, the excess spread trapping point is 4.5.

e. Limit. For a bank subject to the early amortization requirements in this section II.B.7 of appendix E, the aggregate risk-based capital requirement for all of the bank's exposures to a securitization of revolving credit is limited to the greater of (i) the risk-based capital requirement for residual interests (as calculated under section II.B.5 of this appendix E), or (ii) the risk-based capital requirement for the underlying securitized assets calculated as if the bank continued to hold the assets on its balance sheet.

Table EA – Early Amortization Credit Conversion Factors

Excess Spread Trapping Point Ratio	Credit Conversion Factor (CCF)
133.33 percent of trapping point or more	0 percent
less than 133.33 percent to 100 percent of trapping point	5 percent
less than 100 percent to 75 percent of trapping point	15 percent
less than 75 percent to 50 percent of trapping point	50 percent
Less than 50 percent of trapping point	100 percent

C. Risk Weights for Balance Sheet Assets (see Table II)

The risk-based capital framework contains eight risk weight categories--0 percent, 20 percent, 35 percent, 50 percent, 75 percent, 100 percent, 150 percent, and 200 percent.[69] In general, if a

[69] In addition, certain items receive a dollar-for-dollar capital treatment under section II.B.5 of this appendix E.

particular item can be placed in more than one risk category, it is assigned to the category that has the lowest risk weight. An explanation of the components of each category follows:

1—Zero Percent Risk Weight. a. This category includes cash (domestic and foreign) owned and held in all offices of the bank or in transit; balances due from Federal Reserve banks and central banks in other OECD countries; [70] and gold bullion held in the bank's own vaults or in another bank's vaults on an allocated basis, to the extent it is offset by gold bullion liabilities. [71]

b. The zero percent risk category also includes direct claims [72] (including securities, loans, and leases) on, and the portions of claims that are unconditionally guaranteed by the United States and U.S. Government agencies.[73] Federal Reserve Bank stock also is included in this category.

c. This category also includes claims on, and claims guaranteed by, qualifying securities firms[74] incorporated in the United States or other members of the OECD-based group of

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[70] A central government is defined to include departments and ministries, including the central bank, of the central government. The U.S. central bank includes the 12 Federal Reserve banks. The definition of central government does not include state, provincial or local governments or commercial enterprises owned by the central government. In addition, it does not include local government entities or commercial enterprises whose obligations are guaranteed by the central government. OECD central governments are defined as central governments of the OECD-based group of countries. Non-OECD central governments are defined as central governments of countries that do not belong to the OECD-based group of countries.

[71] All other bullion holdings are to be assigned to the 100 percent risk weight category.

[72] For purposes of determining the appropriate risk weights for this risk-based capital framework, the terms "claims" and "securities" refer to loans or other debt obligations of the entity on whom the claim is held. Investments in the form of stock or equity holdings in commercial or financial firms are generally assigned to the 100 percent risk category.

[73] For risk-based capital purposes U.S. Government agency is defined as an instrumentality of the U.S. Government whose debt obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. Government. These agencies include the Government National Mortgage Association (GNMA), the Veterans Administration (VA), the Federal Housing Administration (FHA), the Farmers Home Administration (FHA), the Export-Import Bank (Exim Bank), the Overseas Private Investment Corporation (OPIC), the Commodity Credit Corporation (CCC), and the Small Business Administration (SBA). U.S. Government agencies generally do not directly issue securities to the public; however, a number of U.S. Government agencies, such as GNMA, guarantee securities that are publicly held.

[74] With regard to securities firms incorporated in the United States, qualifying securities firms are those securities firms that are broker-dealers registered with the Securities and Exchange Commission (SEC) and are in compliance with the SEC's net capital rule, 17 CFR 240.15c3--1. With regard to securities firms incorporated in any other country in the OECD-based group of countries, qualifying securities firms are those securities firms that a bank is able to demonstrate are subject to consolidated supervision and regulation (covering their direct and indirect subsidiaries, but not necessarily their parent organizations) comparable to that imposed on banks in OECD countries. Such regulation must include risk-based capital requirements comparable to those applied to banks under the Accord on International Convergence of Capital Measurement and Capital Standards (1988, as amended in

countries that are collateralized by cash on deposit in the lending bank or by securities issued or guaranteed by the United States (including U.S. government Agencies) or OECD central governments, provided that a positive margin of collateral is required to be maintained on such a claim on a daily basis, taking into account any change in a bank's exposure to the obligor or counterparty under the claim in relation to the market value of the collateral held in support of the claim.

d. As provided in sections II.B.3 and II.C.9, this category also includes securities issued by and other claims on a sovereign rated highest investment grade, e.g., AAA, by a NRSRO, in the case of long-term ratings, or highest rating category, e.g., A-1, P-1, in the case of short-term ratings; and claims guaranteed by a sovereign rated highest investment grade by a NRSRO.

2—20 Percent Risk Weight. a. This category includes short-term claims (including demand deposits) on, and portions of short-term claims that are guaranteed [75] by, U.S. depository institutions [76] and foreign banks; [77] portions of claims collateralized by cash held in a segregated

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1998) (Basel Accord). Claims on a qualifying securities firm that are instruments the firm, or its parent company, uses to satisfy its applicable capital requirements are not eligible for this risk weight and are generally assigned to at least a 100 percent risk weight. In addition, certain claims on qualifying securities firms are eligible for a zero percent risk weight if the claims are collateralized by cash on deposit in the lending bank or by securities issued or guaranteed by the United States (including U.S. government agencies), provided that a positive margin of collateral is required to be maintained on such a claim on a daily basis, taking into account any change in a bank's exposure to the obligor or counterparty under the claim in relation to the market value of the collateral held in support of the claim.

[75] Claims guaranteed by U.S. depository institutions include risk participations in both bankers acceptances and standby letters of credit, as well as participations in commitments, that are conveyed to other U.S. depository institutions.

[76] U.S. depository institutions are defined to include branches (foreign and domestic) of federally insured banks and depository institutions chartered and headquartered in the 50 states of the United States, the District of Columbia, Puerto Rico, and U.S. territories and possessions. The definition encompasses banks, mutual or stock savings banks, savings or building and loan associations, cooperative banks, credit unions, international banking facilities of domestic depository institutions, and U.S.-chartered depository institutions owned by foreigners. However, this definition excludes branches and agencies of foreign banks located in the U.S. and bank holding companies.

[77] Foreign banks are distinguished as either OECD banks or non-OECD banks. OECD banks include banks and their branches (foreign and domestic) organized under the laws of countries (other than the U.S.) that belong to the OECD-based group of countries. Non-OECD banks include banks and their branches (foreign and domestic) organized under the laws of countries that do not belong to the OECD-based group of countries. For risk-based capital purposes, a bank is defined as an institution that engages in the business of banking; is recognized as a bank by the bank supervisory or monetary authorities of the country of its organization or principal banking operations;

deposit account of the lending bank; cash items in process of collection, both foreign and domestic; and long-term claims on, and portions of long-term claims guaranteed by, U.S. depository institutions and OECD banks. [78]

b. This category also includes claims on, or portions of claims guaranteed by U.S. Government-sponsored agencies; [79] and portions of claims (including repurchase agreements) collateralized by securities issued or guaranteed by the United States, U.S. Government agencies, or U.S. Government-sponsored agencies. Also included in the 20 percent risk category are portions of claims that are conditionally guaranteed by U.S. Government agencies or U.S. Government-sponsored agencies. [80]

c. General obligation claims on, or portions of claims guaranteed by, the full faith and credit of states or other political subdivisions of the United States or other countries of the OECD-based group are also assigned to this 20 percent risk category, as well as portions of claims guaranteed by such organizations or collateralized by their securities.[81]

d. As provided in sections II.B.2 and II.B.5, this category also includes recourse obligations, direct credit substitutes, residual interests (other than a credit-enhancing interest-only strip) and asset- or mortgage-backed securities rated in the highest or second highest investment grade

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receives deposits to a substantial extent in the regular course of business; and has the power to accept demand deposits.

[78] Long-term claims on, or guaranteed by, non-OECD banks are assigned to the 100 percent risk weight category, as are holdings of bank-issued securities that qualify as capital of the issuing banks for risk-based capital purposes.

[79] For risk-based capital purposes, U.S. Government-sponsored agencies are defined as agencies originally established or chartered by the U.S. Government to serve public purposes specified by the U.S. Congress but whose debt obligations are not explicitly guaranteed by the full faith and credit of the U.S. Government. These agencies include the Federal Home Loan Mortgage Corporation (FHLMC), the Federal National Mortgage Association (FNMA), the Farm Credit System, the Federal Home Loan Bank System, and the Student Loan Marketing Association (SLMA). For risk-based capital purposes, claims on U.S. Government-sponsored agencies also include capital stock in a Federal Home Loan Bank that is held as a condition of membership in that bank.

[80] For risk-based capital purposes, a conditional guarantee is deemed to exist if the validity of the guarantee by the U.S. Government agency is dependent upon some affirmative action (e.g., servicing requirements on the part of the beneficiary of the guarantee). Portions of claims that are unconditionally guaranteed by U.S. Government agencies are assigned to the zero percent risk category.

[81] Claims on, or guaranteed by, states or other political subdivisions of countries that do not belong to the OECD-based group of countries are to be placed in the 100 percent risk weight category.

category, e.g., AAA, AA, in the case of long-term ratings, or the highest rating category, e.g., A-1, P-1, in the case of short-term ratings.

e. As provided in sections II.B.2, II.B.3, and II.C.9, this category also includes securities issued by and other claims on a sovereign rated second-highest or third-highest investment grade by a NRSRO, e.g. AA or A, in the case of long-term ratings, or second-highest investment grade, e.g. A-2, P-2, in the case of short-term ratings; claims guaranteed by a sovereign rated second-highest or third-highest investment grade by a NRSRO; and claims and portions of claims collateralized by securities issued by a sovereign rated second-highest or third-highest investment grade by a NRSRO, in the case of long-term ratings, or second-highest investment grade, in the case of short-term ratings.

f. As provided in sections II.B.2, II.B.3, and II.C.9, this category also includes securities issued by and other claims on a non-sovereign rated highest or second-highest investment grade by a NRSRO, e.g. AAA or AA, in the case of long-term ratings, or highest investment grade, e.g. A-1, P-1, in the case of short-term ratings; claims guaranteed by a non-sovereign whose long-term senior debt is rated highest or second-highest investment grade by a NRSRO; and claims and portions of claims collateralized by securities issued by a non-sovereign rated highest or second-highest investment grade by a NRSRO, in the case of long-term ratings, or highest-investment grade, in the case of short-term ratings.

g. As provided in section II.C.9(b), this category also includes certain one-to-four family residential mortgages.

3--35 Percent Risk Weight.

a. As provided in sections II.B.2 and II.B.5, this category includes recourse obligations, direct credit substitutes, residual interests (other than a credit-enhancing interest-only strip) and asset- or mortgage-backed securities rated third-highest investment grade, e.g., A, in the case of long-term ratings, and second-highest investment grade, e.g. A-2, P-2, in the case of short-term ratings.

b. As provided in sections II.B.2, II.B.3, and II.C.9, this category also includes securities issued by and other claims on a sovereign rated lowest-investment grade plus by a NRSRO, e.g. BBB+, in the case of long-term ratings; claims guaranteed by a sovereign rated lowest-investment grade plus by a NRSRO; and claims and portions of claims collateralized by securities issued by a sovereign rated lowest-investment grade plus by a NRSRO, in the case of long-term ratings.

c. As provided in sections II.B.2, II.B.3, and II.C.9, this category also includes securities issued by and other claims on a non-sovereign rated third-highest investment grade by a NRSRO, e.g. A, in the case of long-term ratings, or second-highest investment grade, e.g. A-2, P-2, in the case of short-term ratings; claims guaranteed by a non-sovereign whose long-term senior debt is rated third-highest investment grade by a NRSRO; and claims and portions of claims collateralized by securities issued by a non-sovereign rated third-highest investment grade by a NRSRO, in the case of long-term ratings, or second-highest investment grade in the case of short-term ratings.

d. As provided in section II.C.9(b), the thirty-five percent risk-weight category also includes certain one-to-four family residential mortgages.

4--50 Percent Risk Weight. a. This category includes loans, secured by one-to-four family residential properties, to builders with substantial project equity for the construction of one-to-four family residences that have been presold under firm contracts to purchasers who have obtained firm commitments for permanent qualifying mortgage loans and have made substantial earnest money deposits.[82] Such loans to builders will be considered prudently underwritten only if the bank has obtained sufficient documentation that the buyer of the home intends to purchase the home (i.e., has a legally binding written sales contract) and has the ability to obtain a mortgage loan sufficient to purchase the home (i.e., has a firm written commitment for permanent financing of the home upon completion), provided the following criteria are met:

(1) The purchaser is an individual(s) who intends to occupy the residence and is not a partnership, joint venture, trust, corporation, or any other entity (including an entity acting as a sole proprietorship) that is purchasing one or more of the homes for speculative purposes;

(2) The builder must incur at least the first ten percent of the direct costs (i.e., actual costs of the land, labor, and material) before any drawdown is made under the construction loan and the construction loan may not exceed 80 percent of the sales price of the presold home;

(3) The purchaser has made a substantial "earnest money deposit" of no less than three percent of the sales price of the home and the deposit must be subject to forfeiture if the purchaser terminates the sales contract; and

(4) The earnest money deposit must be held in escrow by the bank financing the builder or by an independent party in a fiduciary capacity and the escrow agreement must provide that, in the event of default arising from the cancellation of the sales contract by the buyer, the escrow funds must first be used to defray any costs incurred by the bank.

[82] In addition, such loans must have been approved in accordance with prudent underwriting standards, including standards relating to the loan amount as a percent of the appraised value of the property, and the loans must not be past due 90 days or more or carried in nonaccrual status. The types of loans that qualify as loans secured by one-to-four family residential properties are listed in the instructions for preparation of the Consolidated Reports of Condition and Income.

b. This category also includes loans fully secured by first liens on multifamily residential properties,[83] provided that:

(1) The loan amount does not exceed 80 percent of the value[84] of the property securing the loan as determined by the most current appraisal or evaluation, whichever may be appropriate (75 percent if the interest rate on the loan changes over the term of the loan);

(2) For the property's most recent fiscal year, the ratio of annual net operating income generated by the property (before payment of any debt service on the loan) to annual debt service on the loan is not less than 120 percent (115 percent if the interest rate on the loan changes over the term of the loan) or in the case of a property owned by a cooperative housing corporation or nonprofit organization, the property generates sufficient cash flow to provide comparable protection to the bank;

(3) Amortization of principal and interest on the loan occurs over a period of not more than 30 years;

(4) The minimum original maturity for repayment of principal on the loan is not less than seven years;

(5) All principal and interest payments have been made on a timely basis in accordance with the terms of the loan for at least one year before the loan is placed in this category;[85]

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[83] The types of loans that qualify as loans secured by multifamily residential properties are listed in the instructions for preparation of the Consolidated Reports of Condition and Income. In addition, from the stand point of the selling bank, when a multifamily residential property loan is sold subject to a pro rata loss sharing arrangement which provides for the purchaser of the loan to share in any loss incurred on the loan on a pro rata basis with the selling bank when that portion of the loan is not subject to the risk-based capital standards. In connection with sales of multifamily residential property loans in which the purchaser of a loan shares in any loss incurred on the loan with the selling bank on other than a pro rata basis, the selling bank must treat these other loss sharing arrangements in accordance with section II.B.5. of this appendix E.

[84] At the origination of a loan to purchase an existing property, the term "value" means the lesser of the actual acquisition cost or the estimate of value set forth in an appraisal or evaluation, whichever may be appropriate.

[85] In the case where the existing owner of a multifamily residential property refinances a loan on that property, all principal and interest payments on the loan being refinanced must have been made on a timely basis in accordance with the terms of that loan for at least the preceding year. The new loan must meet all of the other eligiblity criteria in order to qualify for a 50 percent risk weight.

(6) The loan is not 90 days or more past due or carried in nonaccrual status; and

(7) The loan has been made in accordance with prudent underwriting standards.

c. This category also includes revenue (non-general obligation) bonds or similar obligations, including loans and leases, that are obligations of states or political subdivisions of the United States or other OECD countries, but for which the government entity is committed to repay the debt with revenues from the specific projects financed, rather than from general tax funds (e.g., municipal revenue bonds).

d. As provided in section II.B.2 and II.B.5, this category also includes recourse obligations, direct credit substitutes, residual interests (other than a credit-enhancing interest-only strip) and asset- or mortgage-backed securities rated lowest investment grade plus, e.g., BBB+, in the case of long-term ratings.

e. As provided in sections II.B.2, II.B.3, and II.C.9, this category also includes securities issued by and other claims on a sovereign rated lowest investment grade naught by a NRSRO, e.g. BBB, in the case of long-term ratings, or lowest investment grade, e.g. A-3, P-3, in the case of short-term ratings; claims guaranteed by a sovereign rated lowest investment grade naught by a NRSRO; and claims and portions of claims collateralized by securities issued by a sovereign rated at least lowest investment grade naught by a NRSRO, in the case of long-term ratings, or lowest investment grade, in the case of short-term ratings.

f. As provided in sections II.B.2, II.B.3, and II.C.9, this category also includes securities issued by and other claims on a non-sovereign rated lowest investment grade plus by a NRSRO, e.g. BBB+, in the case of long-term ratings; claims guaranteed by a non-sovereign whose long-term senior debt is rated lowest investment grade plus by a NRSRO; and claims and portions of claims collateralized by securities issued by a non-sovereign rated lowest investment grade plus by a NRSRO, in the case of long-term ratings.

g. As provided in section II.C.9(b), the fifty percent risk-weight category also includes certain one-to-four family residential mortgages.

5--75 Percent Risk Weight

a. As provided in section II.B.2 and II.B.5, this category also includes recourse obligations, direct credit substitutes, residual interests (other than a credit-enhancing interest-only strip) and asset- or mortgage-backed securities rated lowest investment grade naught, e.g., BBB, in the case of long-term ratings.

b. As provided in sections II.B.2, II.B.3, and II.C.9, this category also includes securities issued by and other claims on a sovereign rated lowest investment grade negative or one category below investment grade plus and naught by a NRSRO, e.g. BBB-, BB+, or BB, in the case of long-term ratings; claims guaranteed by a sovereign rated lowest investment grade negative by a NRSRO, in the case of long-term ratings; and claims and portions of claims collateralized by securities issued by a sovereign rated lowest investment grade negative by a NRSRO, in the case of long-term ratings.

c. As provided in sections II.B.2, II.B.3, and II.C.9, this category also includes certain securities issued by and other claims on a non-sovereign rated lowest investment grade naught by a NRSRO, e.g. BBB, in the case of long-term ratings, or lowest investment grade, A-3, P-3, in the case of short-term ratings; claims guaranteed by a non-sovereign whose long-term debt is rated lowest investment grade naught by a NRSRO; and claims and portions of claims collateralized by securities issued by a non-sovereign rated lowest investment grade naught by a

NRSRO, in the case of long-term ratings, or lowest investment grade, in the case of short-term ratings.

d. As provided in section II.C.9(b), the seventy-five percent risk-weight category also includes certain one-to-four family residential mortgages.

6--100 Percent Risk Weight. a. All assets not included in the above categories in section II.C of this appendix E, except the assets specifically included in the 150 or 200 percent categories below in section II.C of this appendix E and the assets that are otherwise risk weighted in accordance with section II.B, or II.C.9 of this appendix E, are assigned to this category, which comprises standard risk assets.

b. This category includes:

(1) Long-term claims on, and the portions of long-term claims that are guaranteed by, non-OECD banks; [86]

(2) Claims on commercial firms owned by the public sector;

(3) Customer liabilities to the bank on acceptances outstanding involving standard risk claims; [87]

(4) Investments in fixed assets, premises, and other real estate owned;

(5) Common and preferred stock of corporations, including stock acquired for debts previously contracted;

[86] Such assets include all non-local currency claims on, and the portions of claims that are guaranteed by, non-OECD central governments that exceed the local currency liabilities held by the bank.

[87] Customer liabilities on acceptances outstanding involving non-standard risk claims, such as claims on U.S. depository institutions, are assigned to the risk category appropriate to the identity of the obligor or, if relevant, the nature of the collateral or guarantees backing the claims. Portions of acceptances conveyed as risk participations to U.S. depository institutions or foreign banks are assigned to the 20 percent risk category appropriate to short-term claims guaranteed by U.S. depository institutions and foreign banks.

(6) Commercial and consumer loans (except rated loans, loans to sovereigns, and mortgage loans as provided under section II.C.9 and those loans assigned to lower risk categories due to recognized guarantees or collateral)[88];

(7) As provided in sections II.B.2 and II.B.5, recourse obligations, direct credit substitutes, residual interests (other than a credit-enhancing interest-only strip) and asset- or mortgage-backed securities rated lowest investment grade negative, e.g., BBB-, as well as certain positions (but not residual interests) which the bank rates pursuant to section II.B.5(g) of this appendix E;

(8) Industrial-development bonds and similar obligations issued under the auspices of states or political subdivisions of the OECD-based group of countries for the benefit of a private party or enterprise where that party or enterprise, not the government entity, is obligated to pay the principal and interest; and

(9) Stripped mortgage-backed securities and similar instruments, such as interest-only strips that are not credit-enhancing and principal-only strips.

(10) Claims representing capital of a qualifying securities firm.

c. The following assets also are assigned a risk weight of 100 percent if they have not already been deducted from capital: investments in unconsolidated companies, joint ventures, or associated companies; instruments that qualify as capital issued by other banks; deferred tax assets; and mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships.

d. As provided in sections II.B.2, II.B.3, and II.C.9, this category also includes securities issued by and other claims on a sovereign rated at least one category below investment grade

[88] This category includes one-to-four family residential pre-sold construction loans for a residence whose purchase contract is cancelled.

negative by a NRSRO, e.g. BB-, in the case of long-term ratings, or unrated, in the case of short-term ratings.

e. As provided in sections II.B.2, II.B.3, and II.C.9, this category also includes certain securities issued by and other claims on a non-sovereign rated lowest investment grade negative by a NRSRO, e.g. BBB-, in the case of long-term ratings, or unrated, in the case of short-term ratings; claims guaranteed by a non-sovereign whose long-term debt is rated lowest investment grade negative by a NRSRO; and claims and portions of claims collateralized by securities issued by a non-sovereign rated lowest investment grade negative by a NRSRO, in the case of long-term ratings.

f. As provided in section II.C.9(b), the 100 percent risk-weight category also includes certain one-to-four family residential mortgages.

<u>7--150 Percent Risk Weight</u>.

a. As provided in sections II.B.2, II.B.3, and II.C.9, this category includes securities issued by and other claims on a sovereign rated two or more categories below investment grade by a NRSRO, e.g. B or CCC, in the case of long-term ratings.

b. As provided in sections II.B.2, II.B.3, and II.C.9, this category also includes certain securities issued by and other claims on a non-sovereign rated one category below investment grade plus and naught by a NRSRO, e.g. BB+ or BB, in the case of long-term ratings.

c. As provided in section II.C.9, the 150 percent risk-weight category also includes certain one-to-four family residential mortgages.

<u>8--200 Percent Risk Weight</u>. This category includes:

a. As provided in sections II.B.2 and II.B.5, recourse obligations, direct credit substitutes, residual interests (other than a credit-enhancing interest-only strip) and asset- or mortgage-backed securities rated one category below investment grade plus, naught, and negative, e.g. BB+, BB, or BB-, in the case of long-term ratings.

b. As provided in sections II.B.2, II.B.3, and II.C.9, this category also includes securities issued by and other claims on an unrated sovereign.

c. As provided in sections II.B.2, II.B.3, and II.C.9, this category also includes certain securities issued by and other claims on a non-sovereign rated one category below investment grade and below by a NRSRO, e.g. BB+, BB, BB-, B, CCC, and unrated, in the case of long-term ratings.

d. A position (but not a residual interest) in a securitization or structured finance program that is not rated by an NRSRO for which the bank determines that the credit risk is equivalent to one category below investment grade, e.g., BB, to the extent permitted in section II.B.5(g) of this appendix E.

9--Risk Weights for Certain Externally Rated Exposures and Certain Residential Mortgages

a. Externally Rated Exposures. (i) Banks must assign an exposure to a sovereign or non-sovereign to the appropriate risk weight category in accordance with Tables R1 and R2 below. Such exposures include but are not limited to: sovereign bonds (which may be based on the external rating of the issuing country or of the issued bond); all loans to sovereigns, including unrated loans; securities issued by multilateral lending institutions or regional development banks; corporate debt obligations (senior and subordinated); rated loans[89]; and commercial paper.

[89] Except for loans to sovereigns, loans that are not externally rated are risk weighted under section II.C to appendix A to part 325.

(ii) If a claim or exposure has two or more external ratings, the bank must use the lowest assigned external rating to risk weight the claim in accordance with Tables R1 and R2, and that external rating must apply to the claim or exposure in its entirety. Thus, for banks that hold split or partially-rated instruments, the risk weight that corresponds to the lowest component rating will apply to the entire exposure. For example, a purchased subordinated security where the principal component is rated BBB, but the interest component is rated B, will be subject to the gross-up treatment accorded to residual interests rated B or lower. Similarly, if a portion of an instrument is unrated, the entire exposure will be treated as if it were unrated.

(iii) For exposures to sovereigns, the bank must first look to the rating (if any) on the issue to risk weight the claim. If the issue is unrated, the bank must use the issuer rating to determine the appropriate risk weight.

(iv) The FDIC reserves the authority to override the use of certain external ratings or the external ratings on certain instruments, either on a case-by-case basis or through broader supervisory policy, if necessary or appropriate to address the risk that an instrument or issuer poses to banks.

Table R1: Risk Weights Based on Long-term External Ratings

Long-term rating category	**Examples**	**Non-sovereign Risk Weight**	**Sovereign Risk Weight**
Highest investment grade rating *	AAA	20 percent	0 percent
Second-highest investment grade rating	AA	20 percent	20 percent
Third-highest investment grade rating	A	35 percent	20 percent
Lowest-investment grade rating – plus	BBB+	50 percent	35 percent
Lowest-investment grade rating – naught	BBB	75 percent	50 percent
Lowest-investment grade rating – negative	BBB-	100 percent	75 percent
One category below investment grade – plus & naught	BB+, BB	150 percent	75 percent
One category below investment grade - negative	BB-	200 percent	100 percent
Two or more categories below investment grade	B, CCC	200 percent	150 percent

Unrated (excludes unrated loans to non-sovereigns)**	n/a	200 percent	200 percent

* Long-term claims collateralized by AAA-rated sovereign debt would be assigned to the 20 percent risk weight category.
** Unrated loans to non-sovereigns are risk weighted in accordance with section II.C of appendix A to part 325.

Table R2: Risk Weights Based on Short-Term External Ratings

Short-term rating category	**Examples**	**Non-sovereign Risk Weight**	**Sovereign Risk Weight**
Highest investment grade rating *	A-1, P-1	20 percent	0 percent
Second-highest investment grade rating	A-2, P-2	35 percent	20 percent
Lowest investment grade rating	A-3, P-3	75 percent	50 percent
Unrated	n/a		

* Short-term claims collateralized by A1/P1 rated sovereign debt would be assigned to the 20 percent risk weight category.

b. Residential Mortgages. i. This section II.C.9(b) (including Tables M1, M2, and M3) applies to all residential mortgages secured by a lien on a one-to-four family residential property, except for (i) certain one-to-four family residential pre-sold construction loans, and (ii) certain one-to-four family residential pre-sold construction loans for residences for which the purchase contract is cancelled.[90] The risk weights described in Tables M1 and M2 of this section II.C.9(b) are minimum risk weights. For a mortgage to qualify for these risk weights, it must meet certain

[90] Qualifying one-to-four family residential pre-sold construction loans are risk weighted at 50% under section II.B.4, unless the purchase contract is cancelled, in which case, they are risk weighted at 100% under section II.B.6 of this appendix E. Loans that qualify as mortgages, including junior lien mortgages, that are secured by 1- to 4-family residential properties are listed in the instructions to the commercial bank Call Report. This section II.C.9.b does not apply to transactions where a lien on a one-to-four family residential property has been taken as collateral solely through an abundance of caution and where, as a consequence, the terms have not been made more favorable than they would have been in the absence of the lien. In such as case, the loan would not be considered to be secured by real estate and would not be classifiable as a loan secured by real estate in the Call Reports.

minimum criteria: (i) be fully secured by a lien on a one-to four-family residential property, either owner-occupied or rented, (ii) be prudently underwritten, and (iii) not be 90 days or more past due or carried in nonaccrual status. Mortgages that do not meet these criteria will be risk weighted in accordance with Table M3.

ii. Mortgages subject to this section are risk weighted based on their loan-to-value (LTV) ratio[91] or combined loan-to-value (CLTV) ratio[92] and in accordance with Table M1, Table M2, or Table M3, as applicable, after consideration of any loan level private mortgage insurance (loan level PMI). To calculate the CLTV on a junior lien mortgage, a bank must divide the aggregate principle amount outstanding for the first and junior lien(s) by the appraised value of the property at origination of the first lien. LTV ratios can only be adjusted through loan amortization, except for a loan refinancing where the bank extends additional funds. However, for purposes of calculating the CLTV, banks may adjust the appraised value of the property, as determined at the time of origination of the first lien, based on a new appraisal or evaluation in accordance with the FDIC's appraisal regulations and real estate lending guidelines.[93]

(a) Mortgage loans secured by first liens on one- to four-family residential properties. Mortgage loans secured by first liens on one- to four-family residential properties (first lien mortgages) must be risk-weighted in accordance with Table M1. If a bank holds both the first and junior lien(s) on a residential property and no other party holds an intervening lien, the transaction is treated as a first lien mortgage for purposes of determining the loan-to-value ratio and assigning a risk weight.

[91] For purposes of this section II.C.9.b, the value of the property equals the lower of the purchase price for the property or the value at origination. The value of the property must be based on an appraisal or evaluation of the property in conformance with the FDIC's appraisal regulations and real estate lending guidelines. See 12 CFR part 323, 12 CFR part 365.

[92] The CLTV represents the aggregate principle outstanding on a first lien mortgage and all applicable junior lien mortgages divided by the appraised value of the property at origination of the first lien.

[93] See 12 CFR part 323, 12 CFR part 365.

Table M1: Risk Weights for First Lien One- to Four-Family Residential Mortgages

Loan-to-Value Ratio	Risk Weight
Up to 60%	20%
>60% and up to 80%	35%
>80% and up to 85%	50%
>85% and up to 90%	75%
>90% and up to 95%	100%
>95%	150%

(b) Stand-Alone Junior Liens. Stand-alone junior liens on one- to four-family residential mortgages, including structured mortgages and the on-balance sheet portion of home equity lines of credit, must be risk weighted using the CLTV of the stand-alone junior and all senior liens in accordance with Table M2. The CLTV of the stand-alone junior and all senior liens, where any of the senior liens has a negative amortization feature, must reflect the maximum contractual loan amount under the terms of these liens if they were to fully negatively amortize under the applicable contract.

Table M2: Risk Weights for Stand-Alone Junior Lien 1-4 Family Residential Mortgages

Combined Loan to Value Ratio	Risk Weight
Up to 60%	75%
>60% and up to 90%	100%
>90%	150%

Table M3: Risk Weights for Mortgages Not Meeting Minimum Criteria

Risk Weight under Table M1 or M2 *	Risk Weight
20%, 35%, 50%, 75%, or 100%	100%
150%	150%

*This column represents the risk weight a mortgage would have received under Table M1 or M2 if it had met the minimum criteria required by this section II.C.9(b).

(c) <u>One- to Four-Family Residential Mortgages With Negative Amortization Features</u>. First lien mortgages with negative amortization features are risk weighted in accordance with Table M1. For loans with negative amortization features, the LTV of the loans must be adjusted quarterly to include the amount of any negative amortization. Any remaining potential increase in the mortgage's principal balance permitted through negative amortization is to be treated as a long-term commitment and converted to an on-balance sheet equivalent amount as set forth in section II.D. of this Appendix E. The credit equivalent amount of the commitment is then risk-weighted according to Table M1 based on the loan's "highest contractual LTV ratio." The highest contractual LTV ratio of a first lien mortgage equals (i) the current outstanding principal balance of the loan, [94] plus the credit equivalent amount of the remaining negative amortization commitment, minus the amount covered by any loan-level PMI divided by (ii) the value of the property.[95]

iii. Transitional Rule for Residential Mortgage Exposures. A bank may continue to use appendix A to risk weight those mortgage loans that it owns before it elects to use appendix E.

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[94] As the loan balance increases through negative amortization, the bank must recalculate the outstanding loan amount using the original loan amount plus any increases to the loan amount due to negative amortization.
[95] See footnote 91.

However, the bank must use appendix A to risk weight all such mortgage loans. Mortgage loans approved, acquired, or originated after a bank elects to use appendix E must be risk weighted under appendix E. A bank may only rely on this subsection II.C.9(b)(iii) the first time it elects to use appendix E.

D. Conversion Factors for Off-Balance Sheet Items (see Table III)

The face amount of an off-balance sheet item is generally incorporated into the risk-weighted assets in two steps. The face amount is first multiplied by a credit conversion factor, except as otherwise specified in section II.B.5. of this appendix E for direct credit substitutes and recourse obligations. The resultant credit equivalent amount is assigned to the appropriate risk category according to the obligor or, if relevant, the guarantor, the nature of any collateral, or external credit ratings. [96]

1. Items With a 100 Percent Conversion Factor. (a) Except as otherwise provided in section II.B.5. of this appendix E, the full amount of an asset or transaction supported, in whole or in part, by a direct credit substitute or a recourse obligation. Direct credit substitutes and recourse obligations are defined in section II.B.5 of this appendix E.

(b) Sale and repurchase agreements, if not already included on the balance sheet, and forward agreements. Forward agreements are legally binding contractual obligations to purchase assets with drawdown which is certain at a specified future date. Such obligations include forward

[96] The sufficiency of collateral and guarantees for off-balance-sheet items is determined by the market value of the collateral or the amount of the guarantee in relation to the face amount of the item, except for derivative contracts, for which this determination is generally made in relation to the credit equivalent amount. Collateral and guarantees are subject to the same provisions noted under section II.B. of this appendix E.

purchases, forward forward deposits placed, [97] and partly-paid shares and securities; they do not include commitments to make residential mortgage loans or forward foreign exchange contracts.

(c) Securities lent by a bank are treated in one of two ways, depending upon whether the lender is exposed to risk of loss. If a bank, as agent for a customer, lends the customer's securities and does not indemnify the customer against loss, then the securities transaction is excluded form the risk-based capital calculation. On the other hand, if a bank lends its own securities or, acting as agent for customer, lends the customer's securities and indemnifies the customer against loss, the transaction is converted at 100 percent and assigned to the risk weight category appropriate to the obligor or, if applicable, to the collateral delivered to the lending bank or the independent custodian acting on the lending bank's behalf.

2. Items With a 50 Percent Conversion Factor. a. Transaction-related contingencies are to be converted at 50 percent. Such contingencies include bid bonds, performance bonds, warranties, and performance standby letters of credit related to particular transactions, as well as acquisitions of risk participations in performance standby letters of credits. Performance standby letters of credit (performance bonds) are irrevocable obligations of the bank to pay a third-party beneficiary when a customer (account party) fails to perform on some contractual nonfinancial obligation. Thus, performance standby letters of credit represent obligations backing the performance of nonfinancial or commercial contracts or undertakings. To the extent permitted by law or regulation, performance standby letters of credit include arrangements backing, among other things, subcontractors' and suppliers' performance, labor and materials contracts, and construction bids.

b. The unused portion of commitments with an original maturity exceeding one year. including underwriting commitments and commercial and consumer credit commitments, also are to be

[97] Forward forward deposits accepted are treated as interest rate contracts.

converted at 50 percent. Original maturity is defined as the length of time between the date the commitment is issued and the earliest date on which: (1) the bank can at its option, unconditionally (without cause) cancel the commitment, [98] and (2) the bank is scheduled to (and as a normal practice actually does) review the facility to determine whether or not it should be extended and, on at least an annual basis, continues to regularly review the facility. Facilities that are unconditionally cancelable (without cause) at any time by the bank are not deemed to be commitments, provided the bank makes a separate credit decision before each drawing under the facility.

c.i. Commitments are defined as any legally binding arrangements that obligate a bank to extend credit in the form of loans or lease financing receivables; to purchase loans, securities, or other assets; or to participate in loans and leases. Commitments also include overdraft facilities, revolving credit, home equity and mortgage lines of credit, eligible ABCP liquidity facilities, and similar transactions. Normally, commitments involve a written contract or agreement and a commitment fee, or some other form of consideration. Commitments are included in weighted-risk assets regardless of whether they contain material adverse change clauses or other provisions that are intended to relieve the issuer of its funding obligation under certain conditions. In the case of commitments structured as syndications, where the bank is obligated solely for its pro rata share, only the bank's proportional share of the syndicated commitment is taken into account in calculating the risk-based capital ratio.

ii. Banks that are subject to the market risk rules in appendix C to part 325 are required to convert the notional amount of eligible ABCP liquidity facilities, in form or in substance, with an

[98] In the case of home equity or mortgage lines of credit secured by liens on one-to-four family residential properties, a bank is deemed able to unconditionally cancel the commitment if, at its option, it can prohibit additional extensions of credit, reduce the credit line, and terminate the commitment to the full extent permitted by relevant federal law.

original maturity of over one year that are carried in the trading account at 50 percent to determine the appropriate credit equivalent amount even though those facilities are structured or characterized as derivatives or other trading book assets. Liquidity facilities that support ABCP, in form or in substance, (including those positions to which the market risk rules may not be applied as set forth in section 2(a) of appendix C of this part) that are not eligible ABCP liquidity facilities are to be considered recourse obligations or direct credit substitutes, and assessed the appropriate risk-based capital treatment in accordance with section II.B.5. of this appendix E.

d. In the case of commitments structured as syndications where the bank is obligated only for its pro rata share, the risk-based capital framework includes only the bank's proportional share of such commitments. Thus, after a commitment has been converted at 50 percent, portions of commitments that have been conveyed to other U.S. depository institutions or OECD banks, but for which the originating bank retains the full obligation to the borrower if the participating bank fails to pay when the commitment is drawn upon, will be assigned to the 20 percent risk category. The acquisition of such a participation in a commitment would be converted at 50 percent and the credit equivalent amount would be assigned to the risk category that is appropriate for the account party obligor or, if relevant, to the nature of the collateral or guarantees.

e. Revolving underwriting facilities (RUFs), note issuance facilities (NIFs), and other similar arrangements also are converted at 50 percent. These are facilities under which a borrower can issue on a revolving basis short-term notes in its own name, but for which the underwriting banks have a legally binding commitment either to purchase any notes the borrower is unable to sell by the rollover date or to advance funds to the borrower.

3. Items With a 20 Percent Conversion Factor. Short-term, self-liquidating, trade-related contingencies which arise from the movement of goods are converted at 20 percent. Such contingencies include commercial letters of credit and other documentary letters of credit collateralized by the underlying shipments.

4. Items With a 10 Percent Conversion Factor. a. Unused portions of commitments with an original maturity of one year or less are converted using the 10 percent conversion factor.[99] Unused portions of eligible ABCP liquidity facilities with an original maturity of one year or less that provide liquidity support to ABCP also are converted at 10 percent.

b. Banks that are subject to the market risk rules in appendix C to part 325 are required to convert the notional amount of eligible ABCP liquidity facilities, in form or in substance, with an original maturity of one year or less that are carried in the trading account at 10 percent to determine the appropriate credit equivalent amount even through those facilities are structured or characterized as derivatives or other trading book assets. Liquidity facilities that provide liquidity support to ABCP, in form or in substance, (including those positions to which the market risk rules may not be applied as set forth in section 2(a) of appendix C of this part) that are not eligible ABCP liquidity facilities are to be considered recourse obligations or direct credit substitutes and assessed the appropriate risk-based capital requirement in accordance with section II.B.5 of this appendix.

5. Items with a Zero Percent Conversion Factor. These include unused portions of retail credit card lines and related plans are deemed to be short-term commitments if the bank, in accordance with applicable law, has the unconditional option to cancel the credit line at any time.

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[99] Short-term commitments to originate one- to four-family residential mortgage loans, other than a derivative contract, will continue to be converted to an on-balance-sheet credit equivalent amount using the zero percent conversion factor.

6. Derivative Contracts. The credit-equivalent amount for a derivative contract, or group of derivative contracts subject to a qualifying bilateral netting contract, is assigned to the risk weight category appropriate to the underlying obligor regardless of the type of transaction.

E. Derivative Contracts (Interest Rate, Exchange Rate, Commodity (including precious metal) and Equity Derivative Contracts)

1. Credit equivalent amounts are computed for each of the following off-balance-sheet derivative contracts:

(a) Interest Rate Contracts

(i) Single currency interest rate swaps.

(ii) Basis swaps.

(iii) Forward rate agreements.

(iv) Interest rate options purchased (including caps, collars, and floors purchased).

(v) Any other instrument linked to interest rates that gives rise to similar credit risks (including when-issued securities and forward deposits accepted).

(b) Exchange Rate Contracts

(i) Cross-currency interest rate swaps.

(ii) Forward foreign exchange contracts.

(iii) Currency options purchased.

(iv) Any other instrument linked to exchange rates that gives rise to similar credit risks.

(c) Commodity (including precious metal) or Equity Derivative Contracts

(i) Commodity- or equity-linked swaps.

(ii) Commodity- or equity-linked options purchased.

(iii) Forward commodity- or equity-linked contracts.

(iv) Any other instrument linked to commodities or equities that gives rise to similar credit risks.

2. Exchange rate contracts with an original maturity of 14 calendar days or less and derivative contracts traded on exchanges that require daily receipt and payment of cash variation margin may be excluded from the risk-based ratio calculation. Gold contracts are accorded the same treatment as exchange rate contracts except gold contracts with an original maturity of 14 calendar days or less are included in the risk-based calculation. Over-the-counter options purchased are included and treated in the same way as other derivative contracts.

3. Credit Equivalent Amounts for Derivative Contracts. (a) The credit equivalent amount of a derivative contract that is not subject to a qualifying bilateral netting contract in accordance with section II.E.5. of this appendix E is equal to the sum of:

(i) The current exposure (which is equal to the mark-to-market value, [100] if positive, and is sometimes referred to as the replacement cost) of the contract; and

(ii) An estimate of the potential future credit exposure.

(b) The current exposure is determined by the mark-to-market value of the contract. If the mark-to-market value is positive, then the current exposure is equal to that mark-to-market value. If the mark-to-market value is zero or negative, then the current exposure is zero.

(c) The potential future credit exposure of a contract, including a contract with a negative mark-to-market value, is estimated by multiplying the notional principal amount of the contract

[100] Mark-to-market values are measured in dollars, regardless of the currency or currencies specified in the contract and should reflect changes in both underlying rates, prices and indices, and counterparty credit quality.

by a credit conversion factor. Banks should, subject to examiner review, use the effective rather than the apparent or stated notional amount in this calculation. The credit conversion factors are:

Table III – Conversion Factor Matrix

Remaining maturity	Interest rate	Exchange rate and gold	Equity	Precious metals, ex-cept gold	Other commodi-ties
One year or less	0.0%	1.0%	6.0%	7.0%	10.0%
More than one year to five years	0.5%	5.0%	8.0%	7.0%	12.0%
More than five years	1.5%	7.5%	10.0%	8.0%	15.0%

(d) For contracts that are structured to settle outstanding exposure on specified dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the remaining maturity is equal to the time until the next reset date. For interest rate contracts with remaining maturities of more than one year and that meet these criteria, the conversion factor is subject to a minimum value of 0.5 percent.

(e) For contracts with multiple exchanges of principal, the conversion factors are to be multiplied by the number of remaining payments in the contract. Derivative contracts not explicitly covered by any of the columns of the conversion factor matrix are to be treated as "other commodities."

(f) No potential future exposure is calculated for single currency interest rate swaps in which payments are made based upon two floating rate indices (so called floating/floating or basis swaps); the credit exposure on these contracts is evaluated solely on the basis of their mark-to-market values.

4. Risk Weights and Avoidance of Double Counting. (a) Once the credit equivalent amount for a derivative contract, or a group of derivative contracts subject to a qualifying bilateral netting agreement, has been determined, that amount is assigned to the risk category appropriate to the counterparty, or, if relevant, the guarantor or the nature of any collateral. However, the maximum weight that will be applied to the credit equivalent amount of such contracts is 50 percent.

(b) In certain cases, credit exposures arising from the derivative contracts covered by these guidelines may already be reflected, in part, on the balance sheet. To avoid double counting such exposures in the assessment of capital adequacy and, perhaps, assigning inappropriate risk weights, counterparty credit exposures arising from the types of instruments covered by these guidelines may need to be excluded from balance sheet assets in calculating a bank's risk-based capital ratio.

(c) The FDIC notes that the conversion factors set forth in section II.E.3. of appendix E, which are based on observed volatilities of the particular types of instruments, are subject to review and modification in light of changing volatilities or market conditions.

(d) Examples of the calculation of credit equivalent amounts for these types of contracts are contained in Table III of this appendix E.

5. Netting. (a) For purposes of this appendix E, netting refers to the offsetting of positive and negative mark-to-market values when determining a current exposure to be used in the calculation of a credit equivalent amount. Any legally enforceable form of bilateral netting (that is, netting with a single counterparty) of derivative contracts is recognized for purposes of calculating the credit equivalent amount provided that:

(i) The netting is accomplished under a written netting contract that creates a single legal obligation, covering all included individual contracts, with the effect that the bank would have a claim or obligation to receive or pay, respectively, only the net amount of the sum of the positive and negative mark-to-market values on included individual contracts in the event that a counterparty, or a counterparty to whom the contract has been validly assigned, fails to perform due to default, bankruptcy, liquidation, or similar circumstances;

(ii) The bank obtains a written and reasoned legal opinion(s) representing that in the event of a legal challenge, including one resulting from default, insolvency, bankruptcy or similar circumstances, the relevant court and administrative authorities would find the bank's exposure to be such a net amount under:

(1) The law of the jurisdiction in which the counterparty is chartered or the equivalent location in the case of noncorporate entities and, if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;

(2) The law that governs the individual contracts covered by the netting contract; and

(3) The law that governs the netting contract.

(iii) The bank establishes and maintains procedures to ensure that the legal characteristics of netting contracts are kept under review in the light of possible changes in relevant law; and

(iv) The bank maintains in its file documentation adequate to support the netting of derivative contracts, including a copy of the bilateral netting contract and necessary legal opinions.

(b) A contract containing a walkaway clause is not eligible for netting for purposes of calculating the credit equivalent amount. [101]

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[101] For purposes of this section, a walkaway clause means a provision in a neetting contract that permits a non-defaulting counterparty to make lower payments than it would make otherwise under the contract, or no payment at all, to a defaulter or to the estate of a defaulter, even if a defaulter or the estate of a defaulter is a net creditor under the contract.

(c) By netting individual contracts for the purpose of calculating its credit equivalent amount, a bank represents that it has met the requirements of this appendix E and all the appropriate documents are in the bank's files and available for inspection by the FDIC. Upon determination by the FDIC that a bank's files are inadequate or that a netting contract may not be legally enforceable under any one of the bodies of law described in paragraphs (ii)(1) through (3) of section II.E.5.(a) of this appendix E, underlying individual contracts may be treated as though they were not subject to the netting contract.

(d) The credit equivalent amount of derivative contracts that are subject to a qualifying bilateral netting contract is calculated by adding:

(i) The net current exposure of the netting contract; and

(ii) The sum of the estimates of potential future exposure for all individual contractors subject to the netting contract, adjusted to take into account the effects of the netting contract. [102]

(e) The net current exposure is the sum of all positive and negative mark-to-market values of the individual contracts subject to the netting contract. If the net sum of the mark-to-market values is positive, then the net current exposure is equal to that sum. If the net sum of the mark-to-market values is zero or negative, then the net current exposure is zero.

(f) The effects of the bilateral netting contract on the gross potential future exposure are recognized through application of a formula, resulting in an adjusted add-on amount (Anet). The formula, which employs the ratio of net current exposure to gross current exposure (NGR) is expressed as:

$$Anet=(0.4\times Agross)+0.6(NGR\times Agross)$$

[102] For purposes of calculating potential future credit exposure for foreign exchange contracts and other similar contracts in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts to each party falling due on each value date in each currency.

The effect of this formula is that Anetis the weighted average of Agross, and Agrossadjusted by the NGR.

(g) The NGR may be calculated in either one of two ways--referred to as the counterparty-by-counterparty approach and the aggregate approach.

(i) Under the counterparty-by-counterparty approach, the NGR is the ratio of the net current exposure of the netting contract to the gross current exposure of the netting contract. The gross current exposure is the sum of the current exposure of all individual contracts subject to the netting contract calculated in accordance with section II.E. of this appendix E.

(ii) Under the aggregate approach, the NGR is the ratio of the sum of all of the net current exposures for qualifying bilateral netting contracts to the sum of all of the gross current exposures for those netting contracts (each gross current exposure is calculated in the same manner as in section II.E.5(g)(i) of this appendix E). Net negative mark-to-market values to individual counterparties cannot be used to offset net positive current exposures to other counterparties.

(iii) A bank must use consistently either the counterparty-by-counterparty approach or the aggregate approach to calculate the NGR. Regardless of the approach used, the NGR should be applied individually to each qualifying bilateral netting contract to determine the adjusted add-on for that netting contract.

III. Minimum Risk-Based Capital Ratio

Subject to sections II.B.5 of this appendix E, banks generally will be expected to meet a minimum ratio of qualifying total capital to risk-weighted assets of 8 percent, of which at least 4 percentage points should be in the form of core capital (Tier 1). Any bank that does not meet the minimum risk-based capital ratio, or whose capital is otherwise considered inadequate, generally will be expected to develop and implement a capital plan for achieving an adequate level of capital, consistent with the provisions of this risk-based capital framework and § 325.104, the specific circumstances affecting the individual bank, and the requirements of any related agreements between the bank and the FDIC.

Table I.—Definition of Qualifying Capital

Components	Minimum requirements
(1) CORE CAPITAL (Tier 1)	Must equal or exceed 4% of risk-weighted assets.
(a) Common stockholders' equity	No limit.[1]
(b) Noncumulative perpetual preferred stock and any related surplus	No limit.[1]
(c) Minority interest in equity accounts of consolidated	No limit.[1]
(d) Less: All intangible assets other than certain mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships	([2])
(e) Less: Certain credit-enhancing interest only strips and nonfinancial equity investments required to be deducted from capital.	([3])
(f) Less: Certain deferred tax assets.	([4]).
(2) SUPPLEMENTARY CAPITAL (Tier 2)	Total of tier 2 is limited to 100% of tier 1.[5]
(a) Allowance for loan and lease losses	Limited to 1.25% of weighted-risk assets.[5]
(b) Unrealized gains on certain equity securities[6]	Limited to 45% of pretax net unrealized gains.[6].
(c) Cumulative perpetual and long-term preferred stock (original maturity of 20 years or more) and any related surplus.	No limit within tier 2; long-term preferred is amortized for capital purposes as it approaches maturity.
(d) Auction rate and similar preferred stock (both cumulative and non-cumulative).	No limit within tier 2.
(e) Hybrid capital instruments (including mandatory convertible debt securities).	No limit within tier 2.
(f) Term subordinated debt and intermediate-term	Term subordinated debt and intermediate-

preferred stock (original weighted average maturity of five years or more).	term preferred stock are limited to 50% of Tier 1[5] and amortized for capital purposes as they approach maturity.
(3) DEDUCTIONS (from the sum of tier 1 and tier 2)	
(a) Investments in banking and finance subsidiaries that are not consolidated for regulatory capital purposes.	
(b) Intentional, reciprocal cross-holdings of capital securities issued by banks.	
(c) Other deductions (such as investment in other subsidiaries or joint ventures) as determined by supervisory authority.	On a case-by-case basis or as a matter of policy after formal consideration of relevant issues.
(4) TOTAL CAPITAL	Must equal or exceed 8% of weighted-risk assets.

[1] No express limits are placed on the amounts of nonvoting common, noncumulative perpetual preferred stock, and minority interests that may be recognized as part of Tier 1 capital. However, voting common stockholders' equity capital generally will be expected to be the dominant form of Tier 1 capital and banks should avoid undue reliance on other Tier 1 capital elements.

[2] The amounts of mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships that can be recognized for purposes of calculating Tier 1 capital are subject to the limitations set forth in § 325.5(f). All deductions are for capital purposes only; deductions would not affect accounting treatment.

[3]The amounts of credit-enhancing interest-only strips that can be recognized for purposes of calculating Tier 1 capital are subject to the limitations set forth in § 325.5(f). The amounts of nonfinancial equity investments that must be deducted for purposes of calculating Tier 1 capital are set forth in section II.B.(6) of appendix E to part 325.

[4] Deferred tax assets are subject to the capital limitations set forth in § 325.5(g).

[5] Amounts in excess of limitations are permitted but do not qualify as capital.

[6] Unrealized gains on equity securities are subject to the capital limitations set forth in paragraph 1.A.2.(f) of appendix E to part 325.

Calculation of the Risk-Based Capital Ratio

When calculating the risk-based capital ratio under the framework set forth in this statement of policy, qualifying total capital (the numerator) is divided by risk-weighted assets (the denominator). The process of determining the numerator for the ratio is summarized in Table I. The calculation of the denominator is based on the risk weights and conversion factors that are summarized in Tables II and III.

When determining the amount of risk-weighted assets, balance sheet assets are assigned an appropriate risk weight (see Table II) and off-balance sheet items are first converted to a credit equivalent amount (see Table III) and then assigned to one of the risk weight categories set forth in Table II.

The balance sheet assets and the credit equivalent amount of off-balance sheet items are then multiplied by the appropriate risk weight percentages and the sum of these risk-weighted amounts is the gross risk-weighted asset figure used in determining the denominator of the risk-based capital ratio. Any items deducted from capital when computing the amount of qualifying capital may also be excluded from risk-weighted assets when calculating the denominator for the risk-based capital ratio.

Table II.—Summary of Risk Weights and Risk Categories

Category 1—Zero Percent Risk Weight

(1) Cash (domestic and foreign).

(2) Balances due from Federal Reserve banks.

(3) Direct claims on, and portions of claims unconditionally guaranteed by, the U.S. Treasury and U.S. Government agencies.[103]

(4) Gold bullion held in the bank's own vaults or in another bank's vaults on an allocated basis, to the extent that it is offset by gold bullion liabilities.

(5) Federal Reserve Bank stock.

(6) Claims on, or guaranteed by, qualifying securities firms incorporated in the United States or other members of the OECD-based group of countries that are collateralized by cash on deposit in the lending bank or by securities issued or guaranteed by the United States (including U.S. government agencies) or OECD central governments, provided that a positive margin of collateral is required to be maintained on such a claim on a daily basis, taking into account any change in a bank's exposure to the obligor or counterparty under the claim in relation to the market value of the collateral held in support of the claim.

(7) Certain externally rated exposures as provided under section II.C.9 of this appendix E.

Category 2—20 Percent Risk Weight

(1) Cash items in the process of collection.

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[103] For the purpose of calculating the risk-based capital ratio, a U.S. Government agency is defined as an instrumentality of the U.S. Government whose obligations are fully and explicitly guaranteed as to the timely repayment of principal and interest by the full faith and credit of the U.S. Government.

(2) All claims (long- and short-term) on, and portions of claims (long- and short-term) guaranteed by, U.S. depository institutions and OECD banks.

(3) Short-term (remaining maturity of one year or less) claims on, and portions of short-term claims guaranteed by, non-OECD banks.

(4) Portions of loans and other claims conditionally guaranteed by the U.S. Treasury or U.S. Government agencies.[104]

(5) Securities and other claims on, and portions of claims guaranteed by, U.S. Government-sponsored agencies. [105]

(6) Portions of loans and other claims (including repurchase agreements) collateralized by securities issued or guaranteed by the U.S. Treasury, U.S. Government agencies, or U.S. Government-sponsored agencies.

(7) Portions of loans and other claims collateralized[106] by cash on deposit in the lending bank.

(8) General obligation claims on, and portions of claims guaranteed by, the full faith and credit of states or other political subdivisions of OECD countries, including U.S. state and local governments.

(9) Investments in shares of mutual funds whose portfolios are permitted to hold only assets that qualify for the zero or 20 percent risk categories.

(10) Recourse obligations, direct credit substitutes, residual interests (other than credit-enhancing interest-only strips) and asset- or mortgage-backed securities rated in either of the two

[104] For the purpose of calculating the risk-based capital ratio, a U.S. Government agency is defined as an instrumentality of the U.S. Government whose obligations are fully and explicitly guaranteed as to the timely repayment of principal and interest by the full faith and credit of the U.S. Government.
[105] For the purpose of calculating the risk-based capital ratio, a U.S. Government-sponsored agency is defined as an agency originally established or chartered to serve public purposes specified by the U.S. Congress but whose obligations are not explicitly guaranteed by the full faith and credit of the U.S. Government.
[106] Degree of collateralization is determined by current market value.

highest investment grade categories, e.g., AAA or AA, in the case of long-term ratings, or the highest rating category, e.g., A-1, P-1, in the case of short-term ratings.

(11) Certain externally rated exposures as provided under section II.C.9 of this appendix E.

(12) Certain one-to-four family residential mortgages as provided under section II.C.9 of this appendix E.

Category 3—35 Percent Risk Weight

(1) Recourse obligations, direct credit substitutes, residual interests (other than credit-enhancing interest-only strips) and asset- or mortgage-backed securities rated in the third-highest investment grade category, e.g., A, in the case of long-term ratings, or the second highest rating category, e.g., A-2, P-2, in the case of short-term ratings.

(2) Certain externally rated exposures as provided under section II.C.9 of this appendix E.

(3) Certain one-to-four family residential mortgages as provided under section II.C.9 of this appendix E.

Category 4—50 Percent Risk Weight

(1) Certain presold residential construction loans, provided that the loans were approved in accordance with prudent underwriting standards and are not past due 90 days or more or carried on a nonaccrual status.

(2) Loans fully secured by first liens on multifamily residential properties that have been prudently underwritten and meet specified requirements with respect to loan-to-value ration,

level of annual net operating income to required debt service, maximum amortization period, minimum original maturity, and demonstrated timely repayment performance.

(3) Recourse obligations, direct credit substitutes, residual interests (other than credit-enhancing interest-only strips) and asset- or mortgage-backed securities rated in the lowest-highest investment grade category plus, e.g., BBB+, in the case of long-term ratings.

(4) Revenue bonds or similar obligations, including loans and leases, that are obligations of U.S. state or political subdivisions of the United States or other OECD countries but for which the government entity is committed to repay the debt only out of revenues from the specific projects financed.

(5) Certain externally rated exposures as provided under section II.C.9 of this appendix E.

(6) Certain one-to-four family residential mortgages as provided under section II.C.9 of this appendix E.

<u>Category 5—75 Percent Risk Weight</u>

(1) Recourse obligations, direct credit substitutes, residual interests (other than credit-enhancing interest-only strips) and asset- or mortgage-backed securities rated in the lowest highest investment grade category naught, e.g., BBB, in the case of long-term ratings, or the lowest highest rating category, e.g., A-3, P-3, in the case of short-term ratings.

(2) Certain externally rated exposures as provided under section II.C.9 of this appendix E.

(3) Certain one-to-four family residential mortgages as provided under section II.C.9 of this appendix E.

Category 6—100 Percent Risk Weight

(1) All other claims on private obligors.

(2) Obligations issued by U.S. state or local governments or other OECD local governments (including industrial development authorities and similar entities) that are repayable solely by a private party or enterprise.

(3) Premises, plant, and equipment; other fixed assets; and other real estate owned.

(4) Investments in any unconsolidated subsidiaries, joint ventures, or associated companies--if not deducted from capital.

(5) Instruments issued by other banking organizations that qualify as capital.

(6) Claims on commercial firms owned by the U.S. Government or foreign governments.

(7) Recourse obligations, direct credit substitutes, residual interests (other than credit-enhancing interest-only strips) and asset- or mortgage-backed securities rated in the lowest investment grade category negative, e.g., BBB-, as well as certain positions (but not residual interests) which the bank rates pursuant to section II.B.5(g) of this appendix E.

(8) Other assets, including any intangible assets that are not deducted from capital, and the credit equivalent amounts [107] of off-balance sheet items not assigned to a different risk category, except for certain externally rated exposures and certain one-to-four family residential mortgages as provided under section II.C.9 of this appendix E.

Category 7—150 Percent Risk Weight.

[107] In general for each off-balance sheet item, a conversion factor (see Table III) must be applied to determine the "credit equivalent amount" prior to assigning the off-balance sheet item to a risk weight category.

(1) Certain externally rated exposures as provided under section II.C.9 of this appendix E.

(2) Certain one-to-four family residential mortgages as provided under section II.C.9 of this appendix E.

Category 8—200 Percent Risk Weight.

(1) Externally rated recourse obligations, direct credit substitutes, residual interests (other than credit-enhancing interest-only strips), and asset- and mortgage-backed securities that are rated one category below the lowest investment grade category - negative, e.g., BB, to the extent permitted in section II.B.5(d) of this appendix E.

(2) A position (but not a residual interest) extended in connection with a securitization or structured financing program that is not rated by an NRSRO for which the bank determines that the credit risk is equivalent to one category below investment grade, e.g., BB, to the extent permitted in section II.B.5.(g) of this appendix E.

(3) Certain externally rated exposures as provided under section II.C.9 of this appendix E.