FDIC

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Financial Institution Letter
FIL-75-2011
December 16, 2011

RISK-BASED CAPITAL RULES

Proposed Rule on Risk-Based Capital Standards: *Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions*

Summary: The federal bank regulatory agencies (the Agencies) have jointly issued the attached Notice of Proposed Rulemaking (Proposed Rule) on possible modifications to the risk-based capital standards for market risk by incorporating alternative standards for assessing the creditworthiness of debt and securitization positions.

Statement of Applicability to Institutions with Total Assets under $1 Billion: This Financial Institution Letter is applicable to banks with aggregate trading assets and liabilities equal to at least 10 percent of quarter-end total assets or aggregate trading assets and liabilities equal to at least $1 billion.

Distribution:
FDIC-Supervised Banks (Commercial and Savings)

Suggested Routing:
Chief Executive Officer
Chief Financial Officer
Chief Risk Officer

Related Topics:
Risk-Based Capital Rules
12 CFR Part 325
Basel II
Market Risk

Attachment:
Risk-Based Capital Guidelines: Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions

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Highlights:

The Proposed Rule:

- Amends the proposed rule issued by the agencies on Market Risk in January 2011 to remove all reliance on credit ratings while maintaining consistency with the trading book regime proposed by the Basel Committee on Banking Supervision (Basel Committee) in the July 2009 *Revisions to the Basel II Market Risk Framework*.
- Establishes standardized, risk-based capital requirements for sovereign, public-sector entity, bank, non-financial corporate, financial corporate, and securitization exposures.
- Implements, for trading book exposures, the requirements of Section 939A of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, which prohibits reliance on external credit ratings.
- Ensures that capital requirements are comparable to the standards published by the Basel Committee's proposed charges for such positions.

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KEY ASPECTS OF THE PROPOSED RULE ON RISK-BASED CAPITAL STANDARDS: *MARKET RISK; ALTERNATIVES TO CREDIT RATINGS FOR DEBT AND SECURITIZATION POSITIONS*

Introduction

The attached interagency Notice of Proposed Rulemaking (Proposed Rule) explains how the banking agencies (the Agencies) plan to adopt certain revisions to the current market risk capital rule, without relying on credit ratings, as required by Section 939A of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act). The Proposed Rule would adopt the revisions to the market risk capital standards detailed in *Revisions to the Basel II Market Risk* published by the Basel Committee on Banking Supervision (Basel Committee) in July 2009. The Proposed Rule would be required for banks with worldwide consolidated trading activity equal to at least 10 percent of total assets or $1 billion.

Overview

The Proposed Rule modifies the standardized specific risk section of the rule the Agencies proposed in January 2011[1] to provide risk-based capital requirements for banks with significant exposures to market risk to support the risks arising from such exposures. The Proposed Rule would remove all reliance on credit ratings from the market risk capital requirements, in accordance with Section 939A of the Dodd-Frank Act, and in a manner comparable to the standards agreed to by the Basel Committee.

Specific Treatments in the Proposed Rule

Sovereign Exposures

The agencies are proposing to apply specific risk capital requirements to sovereign debt positions based on Country Risk Classifications (CRCs) published by the Organization for Economic Cooperation and Development.

Public Sector Entities (PSEs)

The agencies are proposing that the specific risk capital requirements for PSE exposures be based on the PSE's home country sovereign CRC, as well as the particular instrument's maturity. This approach would apply to general obligation claims and revenue obligations.

Exposures to Depository Institutions, Foreign Banks, and Credit Unions

The Proposed Rule would apply standardized specific risk capital requirements to exposures to depository institutions, foreign banks, or credit unions based on the applicable CRC of the entity's sovereign of incorporation.

[1] http://www.fdic.gov/regulations/laws/federal/2011/11proposedjan11.pdf.

Non-Financial Corporate Exposures
The Proposed Rule would allow banking organizations to use market-based data and obligor specific historical financial data to differentiate the credit risk associated with publicly traded, non-financial corporate debt positions. The methodology uses a measure of leverage, stock price volatility, and cash flow to measure credit risk.

Financial Corporate Exposures
All financial corporate exposures would be assigned an 8 percent specific risk weighting factor under the proposed rule.

Securitizations
The Proposed Rule contains a simplified version of the Basel II advanced approaches supervisory formula approach (SFA) to assign specific risk capital charges to securitizations and re-securitizations. This treatment is referred to in the Proposed Rule as the simplified supervisory formula approach (SSFA). If a bank cannot, or chooses not to, use the SSFA, the securitization position would be subject to a full deduction from capital, which is roughly the equivalent of a dollar-for-dollar capital requirement.

To calculate the SSFA, a bank would determine: (1) the dollar-weighted average risk weight assigned to the underlying exposures backing the securitization position if those exposures were held directly by the bank under the general risk-based capital rules; (2) the position of the tranche in the deal structure; (3) the calibration parameter, which is 0.5 for securitization positions and 1.5 for re-securitization positions; and (4) the cumulative amount of losses experienced in the underlying exposures.

The SSFA applies a 100 percent specific risk-weighting factor to the most junior portion of a securitization structure up to the dollar-weighted average risk weight assigned to the underlying exposures backing the securitization position if those exposures were held directly by the bank under the general risk-based capital rules. For the remaining securitization tranches, the SSFA would apply a formula to assign a marginal capital requirement per dollar amount of exposure. The SSFA formula would be subject to a supervisory minimum specific risk-weighting floor of 1.6 percent, which would rise based on the cumulative amount of losses experienced in the underlying exposures.

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