

# **Key Aspects of the Proposed Rule on Modifications to the Risk-Based Capital Framework (Basel IA)**

## **Background**

On October 20, 2005, the federal banking and thrift regulatory agencies (Agencies) issued an Advance Notice of Proposed Rulemaking (ANPR) soliciting public comment on possible revisions to U.S. risk-based capital rules that would apply to non-Basel II banking organizations. Together, the Agencies received 73 public comments from banking, trade and other organizations and individuals concerning the issues discussed in the ANPR. After consideration of the comments received, the Agencies developed the attached Notice of Proposed Rulemaking (NPR), which sets forth a number of proposals based on the approaches discussed in the ANPR.

The Agencies believe that the proposals contained in the NPR should improve the risk sensitivity of the existing rules without unduly increasing regulatory burden. These proposals are discussed briefly below.

## **NPR Proposals**

*Opt-In/Opt-Out.* The proposed rule would apply to banks, bank holding companies and savings associations (banking organizations). A banking organization would be able to elect to adopt the revisions to the risk-based capital framework contained in the proposed rule or remain subject to the Agencies' existing risk-based capital rules, unless it is required to use the risk-based capital framework proposed in the Basel II NPR. A banking organization that chooses to adopt the proposed rules would be required to apply all the proposed changes included in the NPR.

*Risk Weights.* The proposed rule would increase the number of risk-weight categories to which credit exposures may be assigned, by adding risk weights of 35, 75, and 150 percent.

Externally Rated Exposures. The proposed rule would expand the use of external credit ratings to risk weight most categories of externally rated exposures, including sovereign and corporate debt securities and rated loans, as shown in Table 1. However, the proposed rule retains the existing risk-based capital treatment for U.S. government and agency exposures, U.S. government-sponsored entity exposures, municipal obligations, and loans that are not externally rated.

Table 1

**Proposed Risk Weights Based on External Ratings  
for Long-Term Exposures**

Long-Term Rating Category	Example	Sovereign Risk Weight	Non-Sovereign Risk Weight	Securitization Exposure* Risk Weight
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 – naught	BBB	50%	75%	75%
Lowest investment grade rating – negative	BBB-	75%	100%	100%
One category below investment grade – plus & naught	BB+, BB	75%	150%	200%
One category below investment grade - negative	BB-	100%	200%	200%
Two or more categories below investment grade	B, CCC	150%	200%	*
Unrated (excludes unrated loans to non-sovereigns)**	n/a	200%	200%	*

\* A securitization exposure includes asset- and mortgage-backed securities, recourse obligations, direct credit substitutes, and residuals (other than a credit-enhancing interest-only strip). For securitization exposures that are externally rated more than one category below investment grade or are unrated, the existing risk-based capital treatment would be used. 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 (OTS).

\*\* Unrated loans to non-sovereigns would continue to be risk weighted under the existing risk-based capital rules.

Recognized Collateral. The proposed rule would expand the range 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, including asset and mortgage-backed securities.

Eligible Guarantors. The proposed rule would expand the range of eligible guarantors by recognizing entities that have long-term senior debt that is externally rated at least investment grade by a nationally recognized statistical rating organization or, in the case of sovereign, has an issuer rating that is at least investment grade.

Residential Mortgages. The proposed rule would allow risk weights to be assigned to residential mortgages based upon loan-to-value ratios and whether a particular mortgage is a first- or second-lien, as shown in Tables 2 and 3. For purposes of determining the loan-to-value ratio, a banking organization would be allowed to take into consideration certain loan-level private mortgage insurance. The proposed rule would also require minimum capital for mortgage loans with negative amortization features that would take into consideration the increased risk associated with these features.

Table 2

**Proposed LTVs and Risk Weights for One-to-Four Family First Liens**

<b>Loan-to-Value Ratio</b>	<b>Risk Weight</b>
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%

Table 3

**Proposed LTVs and Risk Weights for One-to-Four Family Junior Liens**

<b>Combined Loan to Value Ratio</b>	<b>Risk Weight</b>
60% or less	75%
Greater than 60% and less than or equal to 90%	100%
Greater than 90%	150%

Short-Term Commitments. The proposed rule increases the credit conversion factor (CCF) for various commitments, with an original maturity of one year or less, to 10 percent. However, commitments that are unconditionally cancelable would retain a zero percent CCF.

Early Amortization. The proposed rule would assess a risk-based capital charge for securitizations of revolving exposures with early amortization features. The early amortization capital charge would be assessed against the off-balance sheet investors' interest and would be imposed based upon the extent by which the level of excess spread exceeds the early amortization trigger.

Removal of Risk-Weight Limits on Certain Derivative Transactions. The proposed rule would remove the 50 percent risk-weight limit that applies to certain derivative contracts. 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.

Use of Borrower Creditworthiness to Assign Risk Weights. In the ANPR, the Agencies sought comment on the use of assessments of borrower creditworthiness, such as credit scores, in the assignment of risk weights for certain claims. The Agencies continue to evaluate approaches that would consider borrower creditworthiness in risk weighting first-lien and junior-lien mortgages.

*Small Loans to Businesses.* In the ANPR, the Agencies sought comment on whether certain small loans to businesses should qualify for a 75 percent risk weight. The Agencies are seeking further comment on this issue in the NPR.

*Issues Discussed in the ANPR but Not Incorporated in the Proposed Rule.* In the 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 approaches discussed in the ANPR concerning these exposures, the Agencies have decided not to propose any changes to the existing rule with respect to these exposures at this time.

### **Impact Analysis**

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 also make changes to these proposals, if warranted, based on this impact analysis.

### **Request for Comment on Basel II Implementation**

Recently, a number of banking organizations, industry trade associations, regulators and other commentators requested that the Agencies provide core banks<sup>1</sup> with the option of using the standardized approach, as described in the Basel II accord. To assist the Agencies in making a fully informed decision with respect to this issue, the proposed rule seeks comment on all aspects of the following questions and seeks the perspectives of banking organizations of different sizes and complexity.

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<sup>1</sup> The Basel II NPR identifies three types of U.S. banking organizations: (1) institutions subject to the proposed Basel II rule on a mandatory basis (core banks); (2) institutions not subject to the proposed Basel II rule on a mandatory basis, but that choose to voluntarily apply those approaches (opt-in banks); and (3) institutions that are not subject to and do not apply the proposed Basel II rule (general banks). In general a core bank is defined as a depository institution with consolidated total assets of \$250 billion or more, with consolidated on-balance sheet foreign exposure of \$10 billion or more, or a subsidiary of a bank or bank holding company that applies the proposed Basel II rule.

1. 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?

2. 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?

3. 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?

4. 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?

### **Comparison with Basel II**

While the proposed rule would increase the risk sensitivity of the existing risk-based capital rules, the average risk weights assigned to various exposures pursuant to the proposed rule generally would be higher than those assigned to similar exposures under

Basel II. Chart 1 shows the risk weights that FDIC staff believes would be typically assigned to various types of exposures under the proposed rule, compared with the risk weights that were reflected in QIS-4 data for the same exposure types. For comparison purposes, the following charts are provided to show the distribution of risk weights for various exposures as reflected in the QIS-4 data.

Chart 1

**Credit risk weights would favor Basel II adopters**

Exposure Type	Risk weights based on:	
	Proposed Rule (Basel IA)	Basel II Advanced QIS-4 (median)
Small business loans:		
Retail	100%	61%
Other	100%	74%
Commercial real estate:		
High volatility	100%	70%
Other	100%	48%
Other commercial	100%	47%
Typical 1-4 residential mortgage	35%	16%
Typical home equity loan	100%	19%
Credit cards	100%	117%
Other retail loans	100%	56%
AAA-rated Fannie or Freddie MBS	20%	7%

Source: *Summary Findings of the Fourth Quantitative Impact Study* and additional calculations.

Notes: Advanced Approaches median risk weights come from *Summary Findings of the Fourth Quantitative Impact Study*, Tables B and C. The 7 percent risk weight on Fannie Mae and Freddie Mac mortgage-backed securities is based on the QIS-4 instructions to treat Fannie and Freddie MBS as senior, AAA-rated asset-backed securities, even if they may not carry an explicit rating. Advanced Approaches capital requirements for credit cards are likely understated in this table because of the large importance of capital requirements for undrawn lines, requirements that are not present in the Basel IA. Basel IA risk weights for residential mortgages refer to a loan with a current loan-to-value ratio of 80%, after including the effects of loan-level private mortgage insurance.

The Basel II risk weights shown in these charts represent the unexpected loss component and do not reflect additional capital charges that may be assessed under Basel II for expected loss or operational risk. Including expected loss capital charges would not materially affect the overall picture presented by these charts. Operational risk charges would not be tied directly to loans. Operational risk charges in QIS-4 were about 10 percent of the capital charges for credit risk.