



# Federal Register

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Tuesday,  
July 29, 2008

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## Part II

### Department of the Treasury

Office of the Comptroller of the  
Currency

12 CFR Part 3

### Federal Reserve System

12 CFR Parts 208 and 225

### Federal Deposit

### Insurance Corporation

12 CFR Part 325

### Department of the Treasury

Office of Thrift Supervision

12 CFR Part 567

Risk-Based Capital Guidelines; Capital  
Adequacy Guidelines: Standardized  
Framework; Proposed Rule

**DEPARTMENT OF THE TREASURY****Office of the Comptroller of the Currency****12 CFR Part 3**

[Docket ID: OCC–2008–0006]

RIN 1557–AD07

**FEDERAL RESERVE SYSTEM****12 CFR Parts 208 and 225**

[Regulations H and Y; Docket No. R–1318]

**FEDERAL DEPOSIT INSURANCE CORPORATION****12 CFR Part 325**

RIN 3064–AD29

**DEPARTMENT OF THE TREASURY****Office of Thrift Supervision****12 CFR Part 567**

[No. 2008–002]

RIN 1550–AC19

**Risk-Based Capital Guidelines; Capital Adequacy Guidelines: Standardized Framework**

**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) propose a new risk-based capital framework (standardized framework) based on the standardized approach for credit risk and the basic indicator approach for operational risk described in the capital adequacy framework titled “International Convergence of Capital Measurement and Capital Standards: A Revised Framework” (New Accord) released by the Basel Committee on Banking Supervision. The standardized framework generally would be available, on an optional basis, to banks, bank holding companies, and savings associations (banking organizations) that apply the general risk-based capital rules.

**DATES:** Comments on this joint notice of proposed rulemaking must be received by October 27, 2008.

**ADDRESSES:** Comments should be directed to:

OCC: Because paper mail in the Washington, DC area and at the OCC is subject to delay, commenters are encouraged to submit comments by e-mail, if possible. Please use the title “Risk-Based Capital Guidelines; Capital Adequacy Guidelines: Standardized Framework; Proposed Rule and Notice” to facilitate the organization and distribution of the comments. You may submit comments by any of the following methods:

- Federal eRulemaking Portal—“Regulations.gov”: Go to <http://www.regulations.gov>, under the “More Search Options” tab click next to the “Advanced Docket Search” option where indicated, select “Comptroller of the Currency” from the agency drop-down menu, then click “Submit.” In the “Docket ID” column, select OCC–2008–0006 to submit or view public comments and to view supporting and related materials for this notice of proposed rulemaking. The “How to Use This Site” link on the Regulations.gov home page provides information on using Regulations.gov, including instructions for submitting or viewing public comments, viewing other supporting and related materials, and viewing the docket after the close of the comment period.

- E-mail: [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov).

- Mail: Office of the Comptroller of the Currency, 250 E Street, SW., Mail Stop 1–5, Washington, DC 20219.

- Fax: (202) 874–4448.

- Hand Delivery/Courier: 250 E Street, SW., Attn: Public Information Room, Mail Stop 1–5, Washington, DC 20219.

**Instructions:** You must include “OCC” as the agency name and “Docket Number OCC–2008–0006” in your comment. In general, OCC will enter all comments received into the docket and publish them on the Regulations.gov Web site without change, including any business or personal information that you provide such as name and address information, e-mail addresses, or phone numbers. Comments received, including attachments and other supporting materials, are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

You may review comments and other related materials that pertain to this

[insert type of rulemaking action] by any of the following methods:

- **Viewing Comments Electronically:** Go to <http://www.regulations.gov>, under the “More Search Options” tab click next to the “Advanced Document Search” option where indicated, select “Comptroller of the Currency” from the agency drop-down menu, then click “Submit.” In the “Docket ID” column, select “OCC–2008–0006” to view public comments for this rulemaking action.

- **Viewing Comments Personally:** You may personally inspect and photocopy comments at the OCC’s Public Information Room, 250 E Street, SW., Washington, DC. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling (202) 874–5043. Upon arrival, visitors will be required to present valid government-issued photo identification and submit to security screening in order to inspect and photocopy comments.

- **Docket:** You may also view or request available background documents and project summaries using the methods described above.

**Board:** You may submit comments, identified by Docket No. R–1318, 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](mailto: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 Web site 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 a.m. and 5 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 a.m. and 5 p.m.

• *E-mail:* [comments@FDIC.gov](mailto: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 a.m. and 5 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 OTS-2008-0002, by any of the following methods:

• *Federal eRulemaking Portal:* "Regulations.gov": Go to <http://www.regulations.gov>, under the "more Search Options" tab click next to the "Advanced Docket Search" option where indicated, select "Office of Thrift Supervision" from the agency dropdown menu, then click "Submit." In the "Docket ID" column, select "OTS-2008-0002" to submit or view public comments and to view supporting and related materials for this proposed rulemaking. The "How to Use This Site" link on the Regulations.gov home page provides information on using Regulations.gov, including instructions for submitting or viewing public comments, viewing other supporting and related materials, and viewing the docket after the close of the comment period.

• *Mail:* Regulation Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552, Attention: OTS-2008-0002.

• *Facsimile:* (202) 906-6518.

• *Hand Delivery/Courier:* Guard's Desk, East Lobby Entrance, 1700 G Street, NW., from 9 a.m. to 4 p.m. on business days, Attention: Regulation Comments, Chief Counsel's Office, Attention: OTS-2008-0002.

• *Instructions:* All submissions received must include the agency name and docket number for this rulemaking.

All comments received will be entered into the docket and posted on Regulations.gov without change, including any personal information

provided. Comments, including attachments and other supporting materials received are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

• *Viewing Comments Electronically:* Go to <http://www.regulations.gov>, select "Office of Thrift Supervision" from the agency drop-down menu, then click "Submit." Select Docket ID "OTS-2008-0002" to view public comments for this notice of proposed rulemaking.

• *Viewing Comments On-Site:* 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](mailto:public.info@ots.treas.gov), or send a facsimile transmission to (202) 906-6518. (Prior notice identifying the materials you will be requesting will assist us in serving you.) We schedule appointments on business days between 10 a.m. and 4 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:* Margot Schwadron, Senior Risk Expert, (202) 874-6022, Capital Policy Division; Carl Kaminski, Attorney; or Ron Shimabukuro, Senior Counsel, Legislative and Regulatory Activities Division, (202) 874-5090; Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219.

*Board:* Barbara Bouchard, Associate Director, (202) 452-3072; or William Tiernay, Senior Supervisory Financial Analyst, (202) 872-7579, Division of Banking Supervision and Regulation; or Mark E. Van Der Weide, Assistant General Counsel, (202) 452-2263; or April Snyder, Counsel, (202) 452-3099, Legal Division. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), (202) 263-4869.

*FDIC:* Nancy Hunt, Senior Policy Analyst, (202) 898-6643; Ryan Sheller, Capital Markets Specialist, (202) 898-6614; or Bobby R. Bean, Chief, Policy Section, Capital Markets Branch, (202) 898-3575, Division of Supervision and Consumer Protection; or Benjamin W. McDonough, Senior 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:* Michael Solomon, Director, Capital Policy Division, (202) 906-5654; or Teresa Scott, Senior Project Manager, Capital Policy Division, (202) 906-6478,

Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

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## I. Background

In 1989, the agencies implemented a risk-based capital framework for U.S. banking organizations (general risk-based capital rules).<sup>1</sup> The agencies based the framework on the “International Convergence of Capital Measurement and Capital Standards” (Basel I), released by the Basel Committee on Banking Supervision (Basel Committee)<sup>2</sup> in 1988. The general risk-based capital rules established a uniform risk-based capital system that was more risk sensitive and addressed several shortcomings in the capital regimes the agencies used prior to 1989.

In June 2004, the Basel Committee introduced a new capital adequacy framework, the New Accord,<sup>3</sup> that is

<sup>1</sup> 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, subpart B (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).

<sup>2</sup> The Basel Committee 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.

<sup>3</sup> “International Convergence of Capital Measurement and Capital Standards, A Revised Framework, Comprehensive Version,” the Basel Committee on Banking Supervision, June 2006. The text is available on the Bank for International

Settlements Web site at <http://www.bis.org/publ/bcbs128.htm>.

designed to promote improved risk measurement and management processes and better align minimum risk-based capital requirements with risk. The New Accord includes three options for calculating risk-based capital requirements for credit risk and three options for operational risk. For credit risk, the three approaches are: standardized, foundation internal ratings-based, and advanced internal ratings-based. For operational risk, the three approaches are: basic indicator (BIA), standardized, and advanced measurement (AMA). The advanced internal ratings-based approach and the AMA together are referred to as the “advanced approaches.”

On September 25, 2006, the agencies issued a notice of proposed rulemaking to implement the advanced approaches in the United States (advanced approaches NPR).<sup>4</sup> Many of the commenters on the advanced approaches NPR requested that the agencies harmonize certain provisions of the agencies’ proposal with the New Accord and offer the standardized approach in the United States. A number of these commenters supported making the standardized approach available for all U.S. banking organizations.

On December 7, 2007, the agencies issued a final rule implementing the advanced approaches (advanced approaches final rule).<sup>5</sup> The advanced approaches final rule is mandatory for certain banking organizations and voluntary for others. In general, the advanced approaches final rule requires a banking organization that has consolidated total assets of \$250 billion or more, has consolidated on-balance sheet foreign exposure of \$10 billion or more, or is a subsidiary or parent of an organization that uses the advanced approaches (core banking organization) to implement the advanced approaches. The implementation of the advanced approaches has created a bifurcated regulatory capital framework in the United States: one set of risk-based capital rules for banking organizations using the advanced approaches (advanced approaches organizations), and another set for banking organizations that do not use the advanced approaches (general banking organizations).

On December 26, 2006, the agencies issued a notice of proposed rulemaking (Basel IA NPR), which proposed modifications to the general risk-based

capital rules for general banking organizations.<sup>6</sup> One objective of the Basel IA NPR was to enhance the risk sensitivity of the risk-based capital rules without imposing undue regulatory burden. Specifically, the agencies proposed to increase the number of risk-weight categories, expand the use of external ratings for assigning risk weights, broaden recognition of collateral and guarantors, use loan-to-value ratios (LTV ratios) to risk weight most residential mortgages, increase the credit conversion factor for various short-term commitments, assess a risk-based capital requirement for early amortizations in securitizations of revolving retail exposures, and remove the 50 percent risk-weight limit for derivative transactions. The Basel IA NPR also sought comment on the extent to which certain advanced approaches organizations should be permitted to use approaches other than the advanced approaches in the New Accord.

Most commenters on the Basel IA NPR supported the agencies’ goal to make the general risk-based capital rules more risk sensitive without adding undue regulatory burden. However, a number of the commenters representing a broad range of U.S. banking organizations and trade associations urged the agencies to implement the New Accord’s standardized approach for credit risk in the United States. These commenters generally stated that the standardized approach is more risk sensitive than the Basel IA NPR and would more appropriately address the industry’s concerns regarding domestic and international competitiveness. Most of these commenters requested that the U.S. implementation of the standardized approach closely follow the New Accord. Certain commenters also requested that the agencies make some or all of the other options for credit risk and operational risk in the New Accord available in the United States. For example, some commenters preferred implementation of the standardized approach without a separate capital requirement for operational risk. Other commenters supported including one or more of the approaches in the New Accord for operational risk.

## II. Proposed Rule

After considering the comments on both the Basel IA and the advanced approaches NPRs, the agencies have decided not to finalize the Basel IA NPR and to propose instead a new risk-based capital framework that would implement the standardized approach for credit risk, the BIA for operational

Settlements Web site at <http://www.bis.org/publ/bcbs128.htm>.

<sup>4</sup> 71 FR 55830 (September 25, 2006).

<sup>5</sup> 72 FR 69288 (December 7, 2007).

<sup>6</sup> 71 FR 77446 (December 26, 2006).

risk, and related disclosure requirements (collectively, this NPR or this proposal). This NPR generally parallels the relevant approaches in the New Accord. This NPR, however, diverges from the New Accord where the U.S. markets have unique characteristics and risk profiles, notably the proposal for risk weighting residential mortgage exposures. The agencies have also sought to make this NPR consistent where relevant with the advanced approaches final rule.

This NPR would not modify how a banking organization that uses the standardized framework would calculate its leverage ratio requirement.<sup>7</sup> Banking organizations face risks other than credit and operational risks that neither the New Accord nor this NPR addresses. The leverage ratio is a straightforward measure of solvency that supplements the risk-based capital requirements. Consequently, the agencies continue to view the tier 1 leverage ratio and other prudential safeguards such as Prompt Corrective Action as important components of the regulatory capital regime.

*Question 1a: The agencies seek comments on all aspects of this proposal, including risk sensitivity, regulatory burden, and competitive impact.*

The agencies' general risk-based capital rules permit the use of external ratings issued by a nationally recognized statistical rating organization (NRSRO) to assign risk weights to recourse obligations, direct credit substitutes, certain residual interests, and asset- and mortgage-backed securities. The New Accord permits a banking organization to use external ratings to determine risk weights for a broad range of exposures, including sovereign, bank, corporate, and securitization exposures. It also provides, within certain limitations, for the use of both inferred ratings and issuer ratings. As discussed in more detail later in this preamble, the agencies propose that external, issuer, and inferred ratings be used to risk weight various exposures. While the agencies believe that the use of ratings proposed in this NPR can contribute to a more risk-sensitive framework, they are aware of the limitations associated with using credit ratings for risk-based capital purposes and, thus, are particularly interested in comments on the use of such ratings for those purposes.

Numerous bank supervisory groups and committees, including the Basel Committee on Banking Supervision, the Financial Stability Forum, and the Senior Supervisors Group, have undertaken work to better understand the causes for and possible responses to the recent market events, discussing, among numerous other issues, the role of credit ratings. In addition, in March, the President's Working Group on Financial Markets (PWG) issued its report titled "Policy Statement on Financial Market Developments," providing an analysis of the underlying factors contributing to the recent market stress and a set of recommendations to address identified weaknesses. Among its recommendations, the PWG encouraged regulators, including the Federal banking agencies, to review the current use of credit ratings in the regulation and supervision of financial institutions. In this regard, the PWG policy statement noted that certain investors and asset managers failed to obtain sufficient information or to conduct comprehensive risk assessments, with some investors relying exclusively on credit ratings for valuation purposes. More generally, the PWG statement also noted market participants, including originators, underwriters, asset managers, credit rating agencies, and investors, failed to obtain sufficient information or to conduct comprehensive risk assessments on complex instruments, including securitized credits and their underlying asset pools.

The PWG policy statement also acknowledged the steps already taken by credit rating agencies to improve the performance of credit ratings and encouraged additional actions, potentially including the publication of sufficient information about the assumptions underlying their credit rating methodologies; changes to the credit rating process to clearly differentiate ratings for structured products from ratings for corporate and municipal securities; and ratings performance measures for structured credit products and other asset-backed securities readily available to the public in a manner that facilitates comparisons across products and credit ratings.

Most directly relevant to this NPR, the agencies were encouraged to reinforce steps taken by the credit rating agencies through revisions to supervisory policy and regulation, including regulatory capital requirements that use ratings. At a minimum, regulators were urged to distinguish, as appropriate, between ratings of structured credit products and ratings of corporate and municipal

bonds in regulatory and supervisory policies.

*Question 1b: The agencies seek comment on the advantages and disadvantages of the use of external credit ratings in risk-based capital requirements for banking organizations and whether identified weakness in the credit rating process suggests the need to change or enhance any of the proposals in this NPR. The agencies also seek comment on whether additional refinements to the proposals in the NPR should be considered to address more broadly the prudent use of credit ratings by banking organizations. For example, should there be operational conditions for banking organizations to make use of credit ratings in determining risk-based capital requirements, enhancements to minimum capital requirements, or modifications to the supervisory review process?*

The agencies also note that efforts are underway by the BCBS to review the treatment in the New Accord for certain off-balance sheet conduits, resecuritizations, such as collateralized debt obligations referencing asset-backed securities, and other securitization-related risks. The agencies are fully committed to working with the BCBS in this regard and also intend to review the agencies' current approach to securitization transactions to assess whether modifications might be needed. This review will take into account lessons learned from recent market-related events and may result in additional proposals for modification to the risk-based capital rules.

*Question 1c: The agencies seek commenters' views on what changes to the approaches set forth in this NPR, if any, should be considered as a result of recent market events, particularly with respect to the securitization framework described in this NPR.*

#### *A. Applicability of the Standardized Framework*

Most commenters on the Basel IA NPR favored its opt-in approach, whereby a banking organization could voluntarily decide whether or not to use the proposed rules. They supported the flexibility of the opt-in provision and the ability of a general banking organization to remain under the general risk-based capital rules. Commenters observed that many banking organizations choose to hold capital well in excess of regulatory minimums and would not necessarily benefit from a more risk-sensitive capital rule. For these commenters, limiting regulatory burden was a higher priority than increasing the risk

<sup>7</sup> 12 CFR 3.6(b) and (c)(OCC); 12 CFR part 208, Appendix B and 12 CFR part 225, Appendix D (Board); 12 CFR 325.3 (FDIC); and 12 CFR 567.8 (OTS).

sensitivity of their risk-based capital requirements.

The agencies acknowledge this concern and propose to make the standardized framework optional for banking organizations that do not use the advanced approaches final rule to calculate their risk-based capital requirements.<sup>8</sup> Under this NPR, a banking organization that opts to use the standardized framework generally would have to notify its primary Federal supervisor in writing of its intent to use the new rules at least 60 days before the beginning of the calendar quarter in which it first uses the standardized framework. This notice must include a list of any affiliated depository institutions or bank holding companies, if applicable, that seek supervisory exemption from the use of the standardized framework. Before it notifies its primary Federal supervisor, the banking organization should review its ability to implement the proposed rule and evaluate the potential impact on its regulatory capital.

Under this proposal, a banking organization that opts to use this standardized framework could return to the general risk-based capital rules by notifying its primary Federal supervisor in writing at least 60 days before the beginning of the calendar quarter in which it intends to opt out of the standardized framework. The banking organization would have to include in its notice an explanation of its rationale for ceasing to use the standardized framework and identify the risk-based capital framework it intends to use. The primary Federal supervisor would review this notice to ensure that the use of the general risk-based capital rules would be appropriate for that banking organization.<sup>9</sup> The agencies expect that a banking organization would not alternate between the general risk-based capital rules and this standardized framework.

Any general banking organization could generally continue to calculate its risk-based capital requirements using the general risk-based capital rules without notifying its primary Federal supervisor. The primary Federal supervisor would, however, have the authority to require a general banking organization to use a different risk-based

capital rule if that supervisor determines that a particular capital rule is appropriate in light of the banking organization's asset size, level of complexity, risk profile, or scope of operations.

Under section 1(b) of the proposed rule, if a bank holding company opts in to the standardized framework, its subsidiary depository institutions also would apply the standardized framework. Similarly, if a depository institution opts in to the standardized framework, its parent bank holding company (where applicable) and any subsidiary depository institutions of the parent holding company generally would be required to apply the standardized rules as well. Savings and loan holding companies, however, are not subject to risk-based capital rules. Accordingly, if a savings association opts in to the proposed rule, the proposed rule would not apply to the savings and loan holding company or to a subsidiary depository institution of that holding company, unless the subsidiary depository institution is directly controlled by the savings association.

The agencies believe that this approach serves as an important safeguard against regulatory capital arbitrage among affiliated banking organizations. The agencies recognize, however, that there may be infrequent situations where the use of the standardized rules could create undue burden at individual depository institutions within a corporate family. Therefore, under section 1(c) of the proposed rule, a banking organization that would otherwise be required to apply the standardized rule because a related banking organization has elected to apply it may instead use the general risk-based capital rules if its primary Federal supervisor determines in writing that that application of the standardized framework is not appropriate in light of the banking organization's asset size, level of complexity, risk profile, or scope of operations. When seeking such a determination, the banking organization should provide a rationale for its request. The primary Federal supervisor may consider potential capital arbitrage issues within a corporate structure in making its determination.

*Question 2: The agencies seek comment on the proposed applicability of the standardized framework and in particular on the degree of flexibility that should be provided to individual depository institutions within a corporate family, keeping in mind regulatory burden issues as well as ways*

*to minimize the potential for regulatory capital arbitrage.*

In the advanced approaches final rule, the agencies require core banking organizations to use only the most advanced approaches provided in the New Accord. As proposed, the standardized framework generally would be available only for banking organizations that are not core banking organizations.

*Question 3: The agencies seek comment on whether or to what extent core banking organizations should be able to use the proposed standardized framework.*

#### *B. Reservation of Authority*

Under this NPR, a primary Federal supervisor could require a banking organization to hold an amount of capital greater than would otherwise be required if that supervisor determines that the risk-based capital requirements under the standardized framework are not commensurate with the banking organization's credit, market, operational, or other risks. In addition, the agencies expect that there may be instances when the standardized framework would prescribe a risk-weighted asset amount for one or more exposures that was not commensurate with the risks associated with the exposures. In such a case, the banking organization's primary Federal supervisor would retain the authority to require the banking organization to assign a different risk-weighted asset amount for the exposures or to deduct the amount of the exposures from regulatory capital. Similarly, this NPR proposes to authorize a banking organization's primary Federal supervisor to require the banking organization to assign a different risk-weighted asset amount for operational risk if the supervisor were to find that the risk-weighted asset amount for operational risk produced by the banking organization under this NPR is not commensurate with the operational risks of the banking organization.

#### *C. Principle of Conservatism*

The agencies believe that in some cases it may be reasonable to allow a banking organization not to apply a provision of the proposed rule if not doing so would yield a more conservative result. Under section 1(f) of the proposed rule, a banking organization may choose not to apply a provision of the rule to one or more exposures provided that: (i) The banking organization can demonstrate on an ongoing basis to the satisfaction of its primary Federal supervisor that not applying the provision would, in all

<sup>8</sup> The agencies are not proposing in this NPR to make this standardized framework available to banking organizations for which the application of the advanced approaches final rule is mandatory, unless such a banking organization is exempted in writing from the advanced approaches final rule by its primary Federal supervisor.

<sup>9</sup> The primary Federal supervisor may waive the 60-day notice period for opting in to the standardized framework and for returning to the general risk-based capital rules.

circumstances, unambiguously generate a risk-based capital requirement for each exposure greater than that which would otherwise be required under the rule; (ii) the banking organization appropriately manages the risk of those exposures; (iii) the banking organization provides written notification to its primary Federal supervisor prior to applying this principle to each exposure; and (iv) the exposures to which the banking organization applies this principle are not, in the aggregate, material to the banking organization.

The agencies emphasize that a conservative capital requirement for a group of exposures does not reduce the need for appropriate risk management of those exposures. Moreover, the principle of conservatism applies to the determination of capital requirements for specific exposures; it does not apply to the disclosure requirements in section 71 of the proposed rule.

#### *D. Merger and Acquisition Transition Provisions*

A banking organization that uses the standardized framework and that merges with or acquires another banking organization operating under different risk-based capital rules may not be able to quickly integrate the acquired organization's exposures into its risk-based capital system. Under this NPR, a banking organization that uses the standardized framework and that merges with or acquires a banking organization that uses the general risk-based capital rules could continue to use the general risk-based capital rules to calculate the risk-based capital requirements for the merged or acquired banking organization's exposures for up to 12 months following the last day of the calendar quarter during which the merger or acquisition is consummated. The risk-weighted assets of the merged or acquired company calculated under the general risk-based capital rules would be included in the banking organization's total risk-weighted assets. Deductions associated with the exposures of the merged or acquired company would be deducted from the banking organization's tier 1 capital and tier 2 capital.

Similarly, where both banking organizations calculate their risk-based capital requirements under the standardized framework, but the merged or acquired banking organization uses different aspects of the framework, the banking organization may continue to use the merged or acquired banking organization's own systems to determine its organization's risk-weighted assets for, and deductions from capital associated with, the merged

or acquired banking organization's exposures for the same time period.

A banking organization that merges with or acquires an advanced approaches banking organization may use the advanced approaches risk-based capital rules to determine the risk-weighted asset amounts for, and deductions from capital associated with, the merged or acquired banking organization's exposures for up to 12 months after the calendar quarter during which the merger or acquisition consummates. During the period when the advanced approaches risk-based capital rules apply to the merged or acquired company, any allowance for loan and lease losses (ALLL) associated with the merged or acquired company's exposures must be excluded from the banking organization's tier 2 capital. Any excess eligible credit reserves associated with the merged or acquired banking organization's exposures may be included in that banking organization's tier 2 capital up to 0.6 percent of that banking organization's risk-weighted assets. (Excess eligible credit reserves would be determined according to section 13(a)(2) of the advanced approaches risk-based capital rules.)

If a banking organization relies on these merger provisions, it would be required to disclose publicly the amounts of risk-weighted assets and total qualifying capital calculated under the applicable risk-based capital rules for the acquiring banking organization and for the merged or acquired banking organization.

#### *E. Calculation of Tier 1 and Total Qualifying Capital*

This NPR would maintain the minimum risk-based capital ratio requirements of 4.0 percent tier 1 capital to total risk-weighted assets and 8.0 percent total qualifying capital to total risk-weighted assets. A banking organization's total qualifying capital is the sum of its tier 1 (core) capital elements and tier 2 (supplemental) capital elements, subject to various limits, restrictions, and deductions (adjustments). The agencies are not restating the elements of tier 1 and tier 2 capital in the proposed rule. Those capital elements generally would be unchanged from the general risk-based capital rules.<sup>10</sup> Deductions or other adjustments would also be unchanged,

<sup>10</sup> See 12 CFR part 3, Appendix A, section 2 (national banks); 12 CFR part 208, Appendix A, section II (state member banks); 12 CFR part 225, Appendix A, section II (bank holding companies); 12 CFR part 325, Appendix A, section I (state nonmember banks); and 12 CFR 567.5 (savings associations).

except for those provisions discussed below.

Under this NPR, a banking organization would make certain other adjustments to determine its tier 1 and total qualifying capital. Some of these adjustments would be made only to tier 1 capital. Other adjustments would be made 50 percent to tier 1 capital and 50 percent to tier 2 capital. If the amount deductible from tier 2 capital exceeds the banking organization's actual tier 2 capital, the banking organization would have to deduct the shortfall amount from tier 1 capital. Consistent with the agencies' general risk-based capital rules, a banking organization would have to have at least 50 percent of its total qualifying capital in the form of tier 1 capital.

Under this NPR, a banking organization would deduct from tier 1 capital any after-tax gain-on-sale resulting from a securitization. Gain-on-sale means an increase in a banking organization's equity capital that results from a securitization, other than an increase in equity capital that results from the banking organization's receipt of cash in connection with the securitization. The agencies included this deduction to offset accounting treatments that produce an increase in a banking organization's equity capital and tier 1 capital at the inception of a securitization, for example, a gain attributable to a credit-enhancing interest-only strip receivable (CEIO) that results from Financial Accounting Standard (FAS) 140 accounting treatment for the sale of underlying exposures to a securitization special purpose entity (SPE).<sup>11</sup> The agencies expect that the amount of the required deduction would diminish over time as the banking organization realizes the increase in equity capital and, thus, tier 1 capital booked at the inception of the securitization, through actual receipt of cash flows.

Under the general risk-based capital rules, a banking organization must deduct CEIOs, whether purchased or retained, from tier 1 capital to the extent that the CEIOs exceed 25 percent of the banking organization's tier 1 capital. Under this NPR, a banking organization would have to deduct CEIOs from tier 1 capital to the extent they represent after-tax gain-on-sale, and would have to deduct any CEIOs that do not constitute an after-tax gain-on-sale 50 percent from tier 1 capital and 50 percent from tier 2 capital.

<sup>11</sup> See Statement of Financial Accounting Standards No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (September 2000).



Under the FDIC, OCC, and Board general risk-based capital rules, a banking organization must deduct from its tier 1 capital certain percentages of the adjusted carrying value of its nonfinancial equity investments. In contrast, OTS general risk-based capital rules require the deduction of most investments in equity securities from total capital.<sup>12</sup> Under this NPR, however, a banking organization would not deduct these investments. Instead, the banking organization's equity exposures generally would be subject to the treatment provided in Part V of this proposed rule.

A banking organization also would have to deduct from total capital the amount of certain unsettled transactions and certain securitization exposures. These deductions are provided in section 21, section 38, and Part IV of this proposed rule.

Consistent with the advanced approaches final rule, for bank holding companies with consolidated insurance underwriting subsidiaries that are functionally regulated (or subject to comparable supervision and minimum regulatory capital requirements in their home jurisdiction), the following treatment would apply. The assets and liabilities of the subsidiary would be consolidated for purposes of determining the bank holding company's risk-weighted assets. The bank holding company, however, would deduct 50 percent from tier 1 capital and 50 percent from tier 2 capital an amount equal to the insurance underwriting subsidiary's minimum regulatory capital requirement as determined by its functional (or equivalent) regulator. For U.S. regulated insurance subsidiaries, this amount generally would be 200 percent of the subsidiary's Authorized Control Level as established by the appropriate state insurance regulator. Under the general risk-based capital rules, such subsidiaries typically are fully consolidated with the bank holding company.

While the elements of tier 1 and tier 2 capital are the same across the general

risk-based capital rules, the advanced approaches final rule, and this NPR, the deductions from those elements are different for each of the three risk-based capital frameworks. As a result, each framework has a distinct definition of tier 1, tier 2, and total qualifying capital.

Securitization-related deductions create a significant difference in the calculation of tier 1 and tier 2 capital across the three frameworks. Under the general risk-based capital rules, only certain CEIOs must be deducted from capital; all other high-risk exposures for which dollar-for-dollar capital must be held may be "grossed-up" in accordance with the regulatory reporting instructions, effectively increasing the denominator of the risk-based capital ratio but not affecting the numerator. In contrast, under the advanced approaches final rule and this NPR, certain high risk securitization exposures must be deducted directly from total capital. Other significant differences in the definition of tier 1, tier 2, and total qualifying capital across the three frameworks include the treatment of nonfinancial equity investments for banks and bank holding companies, certain equity investments for savings associations, certain unsettled transactions, consolidated insurance underwriting subsidiaries of bank holding companies, and the ALLL/eligible credit reserves.

The different definitions of tier 1, tier 2, and total capital across the risk-based capital frameworks raise a number of issues. The agencies clarified in the preamble to the advanced approaches rule that a banking organization's tier 1 capital and tier 2 capital for all non-regulatory-capital supervisory and regulatory purposes (for example, lending limits and Regulation W quantitative limits) is the banking organization's tier 1 capital and tier 2 capital as calculated under the risk-based capital framework to which it is subject. The agencies did not specifically state a position regarding the numerator of the leverage ratio. One potential approach is for each banking organization to use its applicable risk-based definition of tier 1 capital for determining both the risk-based and leverage capital ratios. Another potential approach is to define a numerator for the tier 1 leverage ratio that would be the same for all banking organizations. This approach could require banks to calculate one measure of tier 1 capital for risk-based capital purposes and another measure of tier 1 capital for leverage ratio purposes.<sup>13</sup>

<sup>13</sup> To the extent that the agencies decide to change the numerator of the leverage ratio, they would

*Question 4: Given the potential for three separate definitions of tier 1 capital under the three frameworks, the agencies solicit comment on all aspects of the tier 1 leverage ratio numerator, including issues related to burden and competitive equity.*

#### F. Calculation of Risk-Weighted Assets

##### (1) Total Risk-Weighted Assets

Under this NPR, a banking organization's total risk-weighted assets would be the sum of its total risk-weighted assets for general credit risk, unsettled transactions, securitization exposures, equity exposures, and operational risk. Banking organizations that use the market risk rule (MRR) would supplement their capital calculations with those provisions.<sup>14</sup>

##### (2) Calculation of Risk-Weighted Assets for General Credit Risk

For each of its general credit risk exposures (that is, credit exposures that are not unsettled transactions subject to section 38 of the proposed rule, securitization exposures, or equity exposures), a banking organization must first determine the exposure amount and then multiply that amount by the appropriate risk weight set forth in section 33 of the proposed rule. General credit risk exposures include exposures to sovereign entities; exposures to supranational entities and multilateral development banks; exposures to public sector entities; exposures to depository institutions, foreign banks, and credit unions; corporate exposures; regulatory retail exposures; residential mortgage exposures; pre-sold construction loans; statutory multifamily mortgage exposures; and other assets.

Generally, the exposure amount for the on-balance sheet component of an exposure is the banking organization's carrying value for the exposure. If the exposure is classified as a security available for sale, however, the exposure amount is the banking organization's carrying value of the exposure adjusted for unrealized gains and losses. The exposure amount for the off-balance sheet component of an exposure is typically determined by multiplying the

propose such changes in a separate rulemaking. As a related matter, the OTS advanced approaches final rule incorrectly states that the leverage ratio is calculated using the revised definition of tier 1 and tier 2 capital. This NPR would remove this provision until the agencies conclusively resolve this matter.

<sup>14</sup> 12 CFR part 3, Appendix B (national banks); 12 CFR part 208, Appendix E (state member banks); 12 CFR part 225, Appendix E (bank holding companies); and 12 CFR part 325, Appendix C (state nonmember banks). OTS intends to codify a market risk capital rule for savings associations at 12 CFR part 567, Appendix D.

<sup>12</sup> OTS general risk-based capital rules require savings associations to deduct all "equity investments" from total capital. 12 CFR 567.5(c)(2)(ii). "Equity investments" are defined to include: (i) Investments in equity securities (other than investments in subsidiaries, equity investments that are permissible for national banks, indirect ownership interests in certain pools of assets (for example, mutual funds), Federal Home Loan Bank stock and Federal Reserve Bank stock); and (ii) investments in certain real property. 12 CFR 567.1. The proposed treatment of investments in equity securities is discussed above. Equity investments in real estate would continue to be deducted to the same extent as under the general risk-based capital rules.



notional amount of the off-balance sheet component by the appropriate credit conversion factor (CCF) under section 34 of the proposed rule. The exposure amount for over-the-counter (OTC) derivative contracts is determined under section 35 of the proposed rule.

Exposure amounts for collateralized OTC derivative contracts, repo-style transactions, or eligible margin loans may be determined under particular rules in section 37 of the proposed rule.

### (3) Calculation of Risk-Weighted Assets for Unsettled Transactions, Securitization Exposures, and Equity Exposures

#### (a) Unsettled Transactions

Risk-weighted assets for specified unsettled and failed securities, foreign exchange, and commodities transactions are calculated according to paragraph (f) of section 38 of the proposed rule.<sup>15</sup>

#### (b) Securitization Exposures

Risk-weighted assets for securitization exposures are calculated according to Part IV of the proposed rule. Generally, a banking organization would calculate the risk-weighted asset amount of a securitization exposure by multiplying the amount of the exposure as determined in section 42 of the proposed rule by the appropriate risk weight in section 43 of this NPR.

Part IV of the proposed rule provides a hierarchy of approaches for calculating risk-weighted assets for securitization exposures. Among the approaches included in Part IV is a ratings-based approach (RBA), which calculates the risk-weighted asset amount of a securitization exposure by multiplying the amount of the exposure by risk-weights that correspond to the applicable external or applicable inferred rating of the securitization. Part IV provides other treatments for specific types of securitization exposures including deduction from capital for certain exposures, and different risk-weighted asset computations for certain securitizations exposures that do not qualify for the RBA and for securitizations that have an early amortization provision.

#### (c) Equity Exposures

Risk-weighted assets for equity exposures are calculated according to the rules in Part V of the proposed rule. Generally, risk-weighted assets for equity exposures that are not exposures to investment funds would be calculated according to the simple risk-

weight approach (SRWA) in section 52 of this proposed rule. Risk-weighted assets for equity exposures to investment funds would, with certain exceptions, be calculated according to one of three look-through approaches or, if the investment fund qualifies, calculated according to the money market fund approach. These approaches are described in section 53 of the proposed rule.

### (4) Calculation of Risk-Weighted Assets for Operational Risk

Risk-weighted assets for operational risk are calculated under the BIA provided in section 61 of this proposed rule.

### G. External and Inferred Ratings

#### (1) Overview

The agencies' general risk-based capital rules permit the use of external ratings issued by a nationally recognized statistical rating organization (NRSRO) to assign risk weights to recourse obligations, direct credit substitutes, residual interests (other than a credit-enhancing interest-only strip), and asset- and mortgage-backed securities.<sup>16</sup> Under the ratings-based approach in the general risk-based capital rules, a banking organization must use the lowest NRSRO external rating if multiple ratings exist. The approach also requires one rating for a traded exposure and two ratings for a non-traded exposure and allows the use of inferred ratings within a securitization structure. When the agencies revised their general risk-based capital rules to permit the use of external ratings issued by an NRSRO for these exposures, the agencies acknowledged that these ratings eventually could be used to determine the risk-based capital requirements for other types of debt instruments, such as externally rated corporate bonds.

The New Accord would permit a banking organization to use external ratings to determine risk weights for a broad range of exposures. It also provides for the use of both inferred and, within certain limitations, issuer ratings, but discourages the use of unsolicited ratings. Generally consistent with the New Accord, and in response to favorable comments on the Basel IA NPR's proposal to expand the use of external ratings, the agencies propose that external, issuer, and inferred ratings

be used to risk weight various exposures.

This proposed use of ratings is a more risk-sensitive approach than relying on membership in the Organization for Economic Cooperation and Development (OECD)<sup>17</sup> to differentiate the risk of exposures to sovereign entities, depository institutions, foreign banks, and credit unions. The proposed approach also would use a greater number of risk weights than the general risk-based capital rules, which would further improve the risk sensitivity of a banking organization's risk-based capital requirements.

Consistent with the agencies' general risk-based capital rules and the advanced approaches final rule, the agencies propose to recognize only credit ratings that are issued by an NRSRO. For the purposes of this NPR, NRSRO means an entity registered with the U.S. Securities and Exchange Commission (SEC) as an NRSRO under section 15E of the Securities Exchange Act of 1934 (15 U.S.C. 780-7).<sup>18</sup>

#### (2) Use of External Ratings

Under this NPR, a banking organization would use the applicable external rating of an exposure (for certain exposures that have external ratings) to determine its risk weight. Additionally, consistent with the New Accord, the banking organization would infer a rating for certain exposures that do not have external ratings from the issuer rating of the obligor or from the external rating of another specific issue of the obligor. The agencies' proposal for the use of external and inferred ratings, however, differs in some respects from the New Accord, as described below.

#### (a) External Ratings

Under this NPR, an external rating means a credit rating that is assigned by an NRSRO to an exposure, provided that the credit rating fully reflects the entire amount of credit risk with regard to all payments owed to the holder of the exposure. If, for example, a holder is

<sup>17</sup> 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 IMF's General Arrangements to Borrow. The list of OECD countries is available on the OECD Web site at <http://www.oecd.org>.

<sup>18</sup> See 17 CFR 240.17g-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 to determine whether any modification of the agencies' definition of an NRSRO is appropriate.

<sup>15</sup> Certain transaction types are excluded from the scope of section 38, as provided in paragraph (b) of section 38.

<sup>16</sup> Some synthetic structures also may 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).

owed principal and interest on an exposure, the credit rating must fully reflect the credit risk associated with timely repayment of principal and interest. If a holder is owed only principal on an exposure, the credit rating must fully reflect only the credit risk associated with timely repayment of principal. Furthermore, a credit rating would qualify as an external rating only if it is published in an accessible form and is or will be included in the transition matrices made publicly available by the NRSRO that summarize the historical performance of positions rated by the NRSRO. An external rating may be either solicited or unsolicited by the obligor issuing the rated exposure. This definition is consistent with the definition of "external rating" in the advanced approaches final rule.

Under this NPR, a banking organization would determine the risk weight for certain exposures with external ratings based on the applicable external ratings of the exposures. If an exposure to a sovereign or public sector entity (PSE), a corporate exposure, or a securitization exposure has only one external rating, that rating is the applicable external rating. If such an exposure has multiple external ratings, the applicable external rating would be the lowest external rating. This approach for determining the applicable external rating differs from the New Accord. In the New Accord, if an exposure has two external ratings, a banking organization would apply the lower rating to the exposure to determine the risk weight. If an exposure has three or more external ratings, the banking organization would use the second lowest external rating to risk weight the exposure. The agencies believe that the proposed approach, which is designed to mitigate the potential for external ratings arbitrage, more reliably promotes safe and sound banking practices.

#### (b) Inferred Ratings

Consistent with the New Accord, the agencies propose that a banking organization must, subject to certain conditions, infer a rating on an exposure to a sovereign entity or a PSE or on a corporate exposure that does not have an applicable external rating (unrated exposure).<sup>19</sup> An inferred rating may be based on the issuer rating of the sovereign, PSE, or corporate obligor or based on another externally rated exposure of that obligor. Exposures with an inferred rating would be treated the

same as exposures with an identical external rating.

#### (i) Determining Inferred Ratings

To determine the risk weight for an unrated exposure to a sovereign entity or a PSE, or for an unrated corporate exposure, a banking organization must first determine if, within the framework established in this NPR, the exposure has one or more inferred ratings. An unrated exposure may have inferred ratings based both on the issuer ratings of the obligor and the external ratings of specific issues of the obligor. A banking organization would not be able to use an external rating assigned to an obligor or specific issues of the obligor to infer a rating for an exposure to the obligor's affiliate.

#### (A) Inferred Rating Based on an Issuer Rating

Under this NPR, a senior unrated exposure to a sovereign entity or a PSE, or a senior unrated corporate exposure where the corporate issuer has one or more issuer ratings, has inferred ratings based on those issuer ratings. For purposes of inferring a rating from an issuer rating, a senior exposure would be an exposure that ranks at least *pari passu* (that is, equal) with the obligor's general creditors in the event of bankruptcy, insolvency, or other similar proceeding. This NPR defines an issuer rating as a credit rating assigned by an NRSRO to the obligor that reflects the obligor's capacity and willingness to satisfy all of its financial obligations, and is published in an accessible form and is or will be included in the transition matrices made publicly available by the NRSRO that summarize the historical performance of the NRSRO's ratings.

#### (B) Inferred Rating Based on a Specific Issue Rating

Under this NPR, an unrated exposure to a sovereign entity or a PSE, or an unrated corporate exposure may have one or more inferred ratings based on external ratings assigned to another exposure issued by the obligor. An unrated exposure would have an inferred rating equal to the external rating of another exposure issued by the same obligor and secured by the same collateral (if any), if the externally rated exposure: (i) Ranks *pari passu* with the unrated exposure (or at the banking organization's option, is subordinated in all respects to the unrated exposure); (ii) has a long-term rating; (iii) does not benefit from any credit enhancement that is not available to the unrated exposure, (iv) has an effective remaining maturity that is equal to or longer than

that of the unrated exposure, and (v) is denominated in the same currency as the unrated exposure. The currency requirement would not apply where the unrated exposure that is denominated in a foreign currency arises from a participation in a loan extended by a multilateral development bank or is guaranteed by a multilateral development bank against convertibility and transfer risk. If the banking organization's participation is only partially guaranteed against convertibility and transfer risk, the banking organization could use the external rating for the portion of the participation that benefits from the multilateral development bank's participation. If the externally rated exposure does not meet these requirements, it cannot be used to infer a rating for the unrated exposure.

The inferred rating approach provides a special treatment for inferred ratings from low-quality ratings (ratings that correspond to a risk weight of 100 percent or greater for an exposure to a PSE and 150 percent for an exposure to a sovereign entity or a corporate exposure). An unrated exposure would have inferred rating(s) equal to the long-term external rating(s) of exposures with low-quality ratings that are issued by the same obligor and that are senior in all respects to the unrated exposure.

This approach for inferred ratings differs from the New Accord, which would require that any low-quality rating of an exposure issued by an obligor be assigned to any unrated exposure to the obligor. The agencies have concluded that this treatment could result in an inappropriately high capital charge in some circumstances. For example, an obligor for business reasons may choose to issue subordinated debt that receives a low-quality rating. The New Accord suggests this low-quality rating should be assigned to unrated senior exposures of the obligor, even if the unrated senior exposures are also senior to exposures with a high-quality rating. Under this NPR, a banking organization in that situation could assign the high-quality rating to the unrated senior secured exposure.

#### (ii) Determining the Applicable Inferred Rating

Once a banking organization has determined all the inferred ratings for an unrated exposure, it must determine the applicable inferred rating for the exposure. Under this NPR, the applicable inferred rating for an exposure that has only one inferred rating would be the inferred rating. If the unrated exposure has two or more

<sup>19</sup> The treatment of inferred ratings for securitization exposures is discussed in section M.(4) of this preamble.

inferred ratings, the applicable inferred rating would be the lowest inferred rating.

The agencies believe that this approach for determining the applicable inferred rating for an unrated exposure is appropriately risk sensitive and consistent with the principles for use of external ratings in this NPR and the advanced approaches final rule. The agencies are aware, however, that the proposed use of unsolicited external ratings in this NPR may raise certain issues. The New Accord suggests that banking organizations generally should use solicited ratings and expresses concern that NRSROs might potentially use unsolicited ratings to put pressure on issuers to obtain solicited ratings.

*Question 5: The agencies seek comment on the use of solicited and*

*unsolicited external ratings as proposed in this NPR.*

*H. Risk-Weight Categories*

(1) Exposures to Sovereign Entities

The agencies' general risk-based capital rules generally assign a risk weight to an exposure to a sovereign entity based on the type of exposure and membership of the sovereign in the OECD. Consistent with the New Accord, the agencies propose to risk weight an exposure to a sovereign entity based on the exposure's applicable external or applicable inferred rating (see Table 1).<sup>20</sup>

For purposes of this NPR, sovereign entity means a central government (including the U.S. government) or an agency, department, ministry, or central bank of a central government. In the

United States, this definition would include the twelve Federal Reserve Banks. The definition would not include commercial enterprises owned by the central government that are engaged in activities involving trade, commerce, or profit, which are generally conducted or performed in the private sector.

Where a sovereign entity's banking supervisor allows a banking organization under its jurisdiction to apply a lower risk weight to the same exposure to that sovereign than Table 1 provides, a U.S. banking organization would be able to assign that lower risk weight to its exposures to that sovereign entity provided the exposure is denominated in that sovereign entity's domestic currency, and the banking organization has at least the equivalent amount of liabilities in that currency.

TABLE 1.—EXPOSURES TO SOVEREIGN ENTITIES

| Applicable external or applicable inferred rating for an exposure to a sovereign entity | Example   | Risk weight (in percent) |
|---|-----------|--------------------------|
| Highest investment grade rating .....   | AAA ..... | 0                        |
| Second-highest investment grade rating .....  | AA .....  | 0                        |
| Third-highest investment grade rating .....   | A .....   | 20                       |
| Lowest investment grade rating .....  | BBB ..... | 50                       |
| One category below investment grade .....   | BB .....  | 100                      |
| Two categories below investment grade .....   | B .....   | 100                      |
| Three categories or more below investment grade .....                                   | CCC ..... | 150                      |
| No applicable rating .....  | N/A ..... | 100                      |

(2) Exposures to Certain Supranational Entities and Multilateral Development Banks

Consistent with the New Accord's treatment of exposures to supranational entities, the agencies propose to assign a zero percent risk weight to exposures to the Bank for International Settlements, the European Central Bank, the European Commission, and the International Monetary Fund.

Generally consistent with the New Accord, the agencies also propose that an exposure to a multilateral development bank (MDB) receive a zero percent risk weight. This proposed risk weight would apply only to those MDBs listed below and is based on the generally high credit quality of these MDBs, their strong shareholder support, and a shareholder structure comprised of a significant proportion of sovereign entities with high quality issuer ratings. In this NPR, MDB means the International Bank for Reconstruction and Development, the International Finance Corporation, the Inter-

American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the European Investment Fund, the Nordic Investment Bank, the Caribbean Development Bank, the Islamic Development Bank, the Council of Europe Development Bank, and any other multilateral lending institution or regional development bank in which the U.S. government is a shareholder or contributing member or which the primary Federal supervisor determines poses comparable credit risk. Exposures to regional development banks and multilateral lending institutions that do not meet these requirements would generally be treated as corporate exposures.

(3) Exposures to Depository Institutions, Foreign Banks, and Credit Unions

The agencies' general risk-based capital rules assign a risk weight of 20 percent to all exposures to U.S. depository institutions, foreign banks,

and credit unions incorporated in an OECD country. Short-term exposures to such entities incorporated in a non-OECD country receive a 20 percent risk weight and long-term exposures to such entities in these countries receive a 100 percent risk weight.

Since this NPR eliminates the OECD/non-OECD distinction, the agencies propose that exposures to a depository institution, a foreign bank, or a credit union receive a risk weight based on the lowest issuer rating of the entity's sovereign of incorporation. In this NPR, sovereign of incorporation means the country where an entity is incorporated, chartered, or similarly established. In general, exposures to a depository institution, foreign bank, or credit union would receive a risk weight one category higher than the risk weight assigned to an exposure to the entity's sovereign of incorporation. For exposures to a depository institution, foreign bank, or credit union where the sovereign of incorporation is rated one or two categories below investment grade or is unrated, the risk weight

<sup>20</sup>The ratings examples used throughout this document are illustrative and do not express any preferences or determinations on any NRSRO.

would be 100 percent. If the sovereign of incorporation is rated three or more categories below investment grade, these exposures would receive a risk weight of 150 percent. Table 2 illustrates the proposed risk weights for

exposures to depository institutions, foreign banks, and credit unions. A depository institution is defined as in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813), and foreign bank means a foreign bank as

defined in section 211.2 of the Federal Reserve Board's Regulation K (12 CFR 211.2) other than a depository institution.

TABLE 2.—EXPOSURES TO DEPOSITORY INSTITUTIONS, FOREIGN BANKS, AND CREDIT UNIONS

| Lowest issuer rating of the sovereign of incorporation | Example   | Exposure risk weight (in percent) |
|--|-----------|-----------------------------------|
| Highest investment grade rating .....                  | AAA ..... | 20                                |
| Second-highest investment grade rating .....           | AA .....  | 20                                |
| Third-highest investment grade rating .....            | A .....   | 50                                |
| Lowest investment grade rating .....                   | BBB ..... | 100                               |
| One category below investment grade .....              | BB .....  | 100                               |
| Two categories below investment grade .....            | B .....   | 100                               |
| Three categories or more below investment grade .....  | CCC ..... | 150                               |
| No issuer rating .....                                 | N/A ..... | 100                               |

Consistent with the general risk-based capital rules and the New Accord, exposures to a depository institution or foreign bank that are includable in the regulatory capital of that institution would receive a risk weight no lower than 100 percent unless the exposure is subject to deduction as a reciprocal holding.<sup>21</sup>

The proposal outlined above is consistent with one of the two options available in the New Accord for risk weighting claims on banks. The alternative approach, which the agencies propose for exposures to PSEs, risk weights exposures based on the applicable external or applicable inferred rating of the exposures. This alternative approach for exposures to PSEs is described below.

*Question 6: The agencies seek comment on this proposed approach, as well as on the appropriateness of*

*applying the alternative approach to exposures to depository institutions, credit unions, and foreign banks.*

(4) Exposures to Public Sector Entities (PSEs)

The agencies' general risk-based capital rules assign a 20 percent risk weight to general obligations of states and other political subdivisions of OECD countries.<sup>22</sup> Exposures to entities that rely on revenues from specific projects, rather than general revenues (for example, revenue bonds), receive a risk weight of 50 percent. Generally, other exposures to state and political subdivisions of OECD countries (including industrial revenue bonds) and exposures to political subdivisions of non-OECD countries receive a risk weight of 100 percent.

Consistent with the New Accord, the agencies propose that an exposure to a PSE receive a risk weight based on the

applicable external or applicable inferred rating of the exposure. This approach would apply to both general obligation and revenue bonds. In no case, however, may an exposure to a PSE receive a risk weight that is lower than the risk weight that corresponds to the lowest issuer rating of a PSE's sovereign of incorporation (see Table 1 for risk weights for exposures to sovereign entities).

The proposed rule defines a PSE as a state, local authority, or other governmental subdivision below the level of a sovereign entity. This definition would not include commercial companies owned by a government that engage in activities involving trade, commerce, or profit, which are generally conducted or performed in the private sector. Table 3 illustrates the risk weights for exposures to PSEs.

TABLE 3.—EXPOSURES TO PUBLIC SECTOR ENTITIES: LONG-TERM CREDIT RATING

| Applicable external or applicable inferred rating of an exposure to a PSE | Example   | Risk weight (in percent) |
|---|-----------|--------------------------|
| Highest investment grade rating .....                                     | AAA ..... | 20                       |
| Second-highest investment grade rating .....                              | AA .....  | 20                       |
| Third-highest investment grade rating .....                               | A .....   | 50                       |
| Lowest investment grade rating .....                                      | BBB ..... | 50                       |
| One category below investment grade .....                                 | BB .....  | 100                      |
| Two categories below investment grade .....                               | B .....   | 100                      |
| Three categories or more below investment grade .....                     | CCC ..... | 150                      |
| No applicable rating .....  | N/A ..... | 50                       |

The New Accord also suggests that a national supervisor may permit a banking organization to assign a risk weight to an exposure to a PSE as if it

were an exposure to the sovereign entity in whose jurisdiction the PSE is established. The agencies are not proposing to risk weight exposures to

PSEs in the United States in this manner. In certain cases, however, the agencies have allowed a banking organization to rely on the risk weight

<sup>21</sup> 12 CFR part 3, Appendix A, section 2(c)(6)(ii) (OCC); 12 CFR parts 208 and 225, Appendix A, section II.B.3 (FRB); 12 CFR part 325, Appendix A, I.B.(4) (FDIC); and 12 CFR 567.5(c)(2)(i) (OTS).

<sup>22</sup> Political subdivisions of the United States include 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.

that a foreign banking supervisor assigns to its own PSEs. Therefore, the agencies propose to allow a banking organization to risk weight an exposure to a foreign PSE according to the risk weight that the foreign banking supervisor assigns. In no event, however, could the risk weight for an exposure to a foreign PSE be lower than the lowest risk weight assigned to that PSE's sovereign of incorporation.

The New Accord contains an alternative approach to risk weight exposures to a PSE, which is based on the lowest issuer rating of the PSE's

sovereign of incorporation. The agencies are proposing this approach for exposures to depository institutions, foreign banks, and credit unions as described in the previous section.

*Question 7: The agencies seek comment on the pros and cons of the proposed approach for risk weighting exposures to PSEs as well as on the appropriateness of applying, instead, the approach proposed in this NPR for depository institutions.*

The New Accord does not incorporate the use of short-term ratings for exposures to PSEs. The agencies

recognize, however, that an NRSRO may assign a short-term municipal rating to an exposure to a PSE that has a maturity of up to three years (for example, a bond anticipation note). Further, the agencies understand that there are different techniques for comparing these short-term ratings to other types of ratings, both short-term and long-term. The agencies are considering whether to permit the use of these short-term ratings for risk weighting short-term exposures to PSEs using the risk weights in Table 4.

TABLE 4.—PUBLIC SECTOR ENTITIES: SHORT-TERM RATINGS

| Applicable external rating of an exposure to a PSE | Example          | Risk weight (in percent) |
|--|------------------|--------------------------|
| Highest investment grade .....                     | SP-1/MIG-1 ..... | 20                       |
| Second-highest investment grade .....              | SP-2/MIG-2 ..... | 50                       |
| Third-highest investment grade .....               | SP-3/MIG-3 ..... | 100                      |
| Below investment grade .....                       | Non-prime .....  | 150                      |
| No applicable external rating .....                | N/A .....        | 50                       |

*Question 8: The agencies solicit comment on the use of short-term ratings for exposures to PSEs generally and specifically on the ratings and related risk weights in Table 4.*

(5) Corporate Exposures

Under the agencies' general risk-based capital rules, most corporate exposures receive a risk weight of 100 percent. Exposures to securities firms incorporated in the United States or in an OECD country may receive a 20 percent risk weight if they meet certain requirements, and exposures to U.S. government-sponsored agencies or entities (GSEs) may also receive a 20 percent risk weight. GSEs include an agency or corporation originally established or chartered by the U.S. Government 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.

In this NPR, corporate exposure means a credit exposure to a natural

person or a company (including an industrial development bond, an exposure to a GSE, or an exposure to a securities broker or dealer) that is not an exposure to: a sovereign entity, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, an MDB, a depository institution, a foreign bank, a credit union, or a PSE; a regulatory retail exposure; a residential mortgage exposure; a pre-sold construction loan; a statutory multifamily mortgage; a securitization exposure; or an equity exposure.

Consistent with the New Accord, the agencies propose to permit a banking organization to elect one of two methods to risk weight corporate exposures. Regardless of the method a banking organization chooses, it would have to use that approach consistently for all corporate exposures. First, a banking organization could risk weight all of its corporate exposures at 100 percent without regard to external ratings. Second, a banking organization could

risk weight a corporate exposure based on its applicable external or applicable inferred rating. Table 5 provides the proposed risk weights for corporate exposures with applicable external or applicable inferred ratings based on long-term credit ratings. Table 6 provides the proposed risk weights for corporate exposures with applicable external ratings based on short-term credit ratings.

If a corporate exposure has no external rating, that exposure could not receive a risk weight lower than the risk weight that corresponds to the lowest issuer rating of the obligor's sovereign of incorporation in Table 1. In addition, if an obligor has any exposure with a short-term external rating that corresponds to a risk weight of 150 percent under Table 6, a banking organization would assign a 150 percent risk weight to any corporate exposure to that obligor that does not have an external rating and that ranks pari passu with or is subordinated to the externally rated exposure.

TABLE 5.—CORPORATE EXPOSURES: LONG-TERM CREDIT RATING

| Applicable external or applicable inferred rating     | Example   | Exposure risk weight (in percent) |
|---|-----------|-----------------------------------|
| Highest investment grade rating .....                 | AAA ..... | 20                                |
| Second-highest investment grade rating .....          | AA .....  | 20                                |
| Third-highest investment grade rating .....           | A .....   | 50                                |
| Lowest investment grade rating .....                  | BBB ..... | 100                               |
| One category below investment grade .....             | BB .....  | 100                               |
| Two categories below investment grade .....           | B .....   | 150                               |
| Three categories or more below investment grade ..... | CCC ..... | 150                               |
| No applicable rating .....                            | N/A ..... | 100                               |

TABLE 6.—CORPORATE EXPOSURES: SHORT-TERM CREDIT RATING

| Applicable external rating            | Example                   | Exposure risk weight (in percent) |
|---------------------------------------|---------------------------|-----------------------------------|
| Highest investment grade .....        | A-1/P-1 .....             | 20                                |
| Second-highest investment grade ..... | A-2/P-2 .....             | 50                                |
| Third-highest investment grade .....  | A-3/P-3 .....             | 100                               |
| Below investment grade .....          | B, C, and non-prime ..... | 150                               |
| No applicable external rating .....   | N/A .....                 | 100                               |

As provided in the New Accord, this NPR (outside of the securitization framework) would not allow a banking organization to infer a rating from an exposure based on a short-term external rating. Consistent with this position, this NPR does not include the New Accord provision that assigns a risk weight of at least 100 percent to all unrated short-term exposures of an obligor if any rated short-term exposure of that obligor receives a 50 percent risk weight.

*Question 9: The agencies seek comment on the appropriateness of including either or both of these aspects of the New Accord in any final rule implementing the standardized framework.*

The New Accord would treat securities firms that meet certain requirements like depository institutions. The agencies propose, however, to risk weight exposures to securities firms as corporate exposures, parallel with the treatment of bank holding companies and savings association holding companies.

The agencies also propose that exposures to GSEs be treated as corporate exposures and risk weighted based on the NRSRO credit ratings. These ratings on individual GSE exposures are often based in part on the NRSRO assessments of the extent to which the U.S. government might come to the financial aid of a GSE. The agencies believe that risk-weight determinations should not be based on the possibility of U.S. government financial assistance, except where the U.S. government has legally committed to provide such assistance.

In addition to the credit ratings on individual GSE exposures, the NRSROs also publish issuer ratings that evaluate the financial strength of some GSEs without respect to any implied financial assistance from the U.S. government. These financial strength ratings are monitored by the issuing NRSROs but are not included in the NRSROs' transition matrices. Accordingly, the financial strength ratings would not meet the definition of an external rating in this NPR. Further, the use of these

ratings is also problematic because NRSROs provide financial strength ratings for issuers, but not for specific issues, and do not provide the same level of differentiation between short- and long-term debt and various levels of subordination as NRSRO ratings of specific exposures. In addition, NRSROs have not published financial strength ratings for all GSEs.

*Question 10: The agencies seek comment on the use of financial strength ratings to determine risk weights for exposures to GSEs, and seek comment on how such ratings might be applied. The agencies also seek input on how subordination and maturity of exposures could be embodied in such an approach, and what requirements should be developed for recognizing ratings assigned to GSEs.*

(6) Regulatory Retail Exposures

The general risk-based capital rules generally assign a risk weight of 100 percent to non-mortgage retail exposures, secured or unsecured, including personal, auto, and credit card loans. Consistent with the New Accord, the agencies propose that a banking organization apply a 75 percent risk weight to regulatory retail exposures that meet the following criteria: (i) A banking organization's aggregate exposure to a single obligor does not exceed \$1 million; (ii) the exposure is part of a well diversified portfolio; and (iii) the exposure is not an exposure to a sovereign entity, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, an MDB, a PSE, a depository institution, a foreign bank, or a credit union; an acquisition, development and construction loan; a residential mortgage exposure; a pre-sold construction loan; a statutory multifamily mortgage; a securitization exposure; an equity exposure; or a debt security. Examples of regulatory retail exposures would include a revolving credit or line of credit (including credit card and overdraft lines of credit), a personal term loan or lease (including an installment loan, auto loan or lease,

student or educational loan, personal loan), and a facility or commitment to a company.

Any retail exposure that does not meet these requirements generally would be considered a corporate exposure and would receive a risk weight based on the risk-weight tables for corporate exposures (see Tables 5 and 6).

*Question 11: The agencies seek comment on whether a specific numerical limit on concentration should be incorporated into the provisions for regulatory retail exposures. For example, the New Accord suggests a 0.2 percent limit on an aggregate exposure to one obligor as a measure of concentration within the regulatory retail portfolio. The agencies solicit comment on the appropriateness of a 0.2 percent limit as well as on other types of measures of portfolio concentration that may be appropriate.*

(7) Residential Mortgage Exposures

The general risk-based capital rules assign exposures secured by one-to-four family residential properties to either the 50 percent or 100 percent risk weight category. Most exposures secured by a first lien on a one-to-four family residential property meet the criteria to receive a 50 percent risk weight.<sup>23</sup> The New Accord applies a similarly broad treatment to residential mortgages. It provides a risk weight of 35 percent for most first-lien residential mortgage exposures that meet prudential criteria such as the existence of a substantial margin of additional security over the amount of the loan.

In the Basel IA NPR, the agencies proposed to assign a risk weight for one-to-four family residential mortgage exposures based on the LTV ratio. The agencies noted that the LTV ratio is a meaningful indicator of potential loss and borrower default. Commenters on the Basel IA NPR generally supported

<sup>23</sup> 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 ILC.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).

this LTV ratio approach. In this NPR, the agencies propose substantially the same treatment for residential mortgage exposures as was proposed in the Basel IA NPR. Given the characteristics of the U.S. residential mortgage market, the agencies believe that the risk weights in the New Accord do not reflect the appropriate spectrum of risk for these assets. The agencies believe the wider range of risk weights that the agencies proposed in the Basel IA NPR is more appropriate for the U.S. residential mortgage market.

The agencies believe that an LTV ratio approach to residential mortgage exposures would not impose a significant burden on banking organizations because LTV information is readily available and is commonly used in the underwriting process. Use of LTV ratios to assign risk weights to residential mortgage exposures would not substitute for, or otherwise release a banking organization from, its responsibility to have prudent loan underwriting and risk management practices consistent with the size, type, and risk of its mortgage business.<sup>24</sup> Through the supervisory process, the agencies would continue to assess a banking organization's underwriting and risk management practices consistent with supervisory guidance and safety and soundness. The agencies would continue to use their supervisory authority to require a banking organization to hold additional capital for residential mortgage exposures where appropriate.

The proposed rule defines a residential mortgage exposure as an exposure (other than a pre-sold construction loan) that is primarily secured by a one-to-four family residential property. The proposed rule identifies two types of residential mortgage exposures (first-lien residential mortgage exposures and junior-lien residential mortgage exposures), and provides a separate treatment for each type of exposure. A first-lien residential mortgage exposure is a residential mortgage exposure secured by a first lien or a residential mortgage exposure secured by first and junior lien(s) where no other party holds an intervening lien. This treatment is similar to the treatment of mortgage exposures under the general risk-based capital rules. A junior-lien residential mortgage exposure is a residential mortgage exposure that is secured by a

junior lien and that is not a first-lien residential mortgage exposure.

(a) Exposure Amount

The proposed rule provides that a banking organization would hold capital for both the funded and the unfunded portions of residential mortgage exposures. For the funded portion of a residential mortgage exposure, the banking organization would assign a risk weight to the carrying value of the exposure (that is, the principal amount of the exposure). For the unfunded portion of a residential mortgage exposure (for example, potential exposure from a negative amortization feature or a home equity line of credit (HELOC)), a banking organization would risk weight the notional amount of the exposure (that is, the maximum contractual commitment) multiplied by the appropriate credit conversion factor. For a residential mortgage exposure that has both funded and unfunded components, a banking organization would calculate separate risk-weighted asset amounts for the unfunded and funded portions, based on separately calculated LTV ratios as discussed below.

(b) Risk Weights

The agencies propose that a banking organization risk weight first-lien residential mortgage exposures that meet certain qualifying criteria according to Table 7. The risk weights in Table 7 would apply only to a first-lien residential mortgage exposure that is secured by property that is owner-occupied or rented, is prudently underwritten, is not 90 days or more past due, and is not on nonaccrual. A first-lien residential mortgage exposure that has been restructured may receive a risk weight lower than 100 percent, only if the banking organization updates the LTV ratio at the time of the restructuring and according to the discussion below and in section 33 of the proposed rule. First-lien residential mortgage exposures that do not meet these criteria would receive a 100 percent risk weight if they have an LTV ratio less than or equal to 90 percent, and would receive a 150 percent risk weight if they have an LTV ratio greater than 90 percent.

TABLE 7.—RISK WEIGHTS FOR FIRST-LIEN RESIDENTIAL MORTGAGE EXPOSURES

| Loan-to-value ratio (in percent) | Risk weight (in percent) |
|----------------------------------|--------------------------|
| Less than or equal to 60 .....   | 20                       |

TABLE 7.—RISK WEIGHTS FOR FIRST-LIEN RESIDENTIAL MORTGAGE EXPOSURES—Continued

| Loan-to-value ratio (in percent)                   | Risk weight (in percent) |
|--|--------------------------|
| 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                      |

Under the general risk-based capital rules, a banking organization must assign a risk weight to an exposure secured by a junior lien on residential property at 100 percent, unless the banking organization also holds the first lien and there are no intervening liens. The New Accord does not specifically discuss the treatment of exposures secured by junior liens on residential property.

The agencies continue to believe that stand-alone junior-lien residential mortgage exposures have a different risk profile than first-lien residential mortgage exposures and should be risk weighted accordingly. Under the proposed rule, a banking organization would compute an LTV ratio as described below for a junior-lien residential mortgage exposure that is not 90 days or more past due or on nonaccrual based upon the loan amounts for the junior-lien residential mortgage exposure and all senior exposures as described below. The banking organization would then assign a risk weight to the exposure amount of the junior-lien residential mortgage exposure according to Table 8. This treatment is similar to the Basel IA NPR and recognizes that stand-alone junior-lien residential mortgage exposures generally default at a higher rate than first-lien residential mortgage exposures. A banking organization would risk weight a junior-lien residential mortgage exposure that is 90 days or more past due or on nonaccrual at 150 percent.

TABLE 8.—RISK WEIGHTS FOR JUNIOR-LIEN RESIDENTIAL MORTGAGE EXPOSURES

| Loan-to-value ratio (in percent)                   | Risk weight (in percent) |
|--|--------------------------|
| Less than or equal to 60 .....                     | 75                       |
| Greater than 60 and less than or equal to 90 ..... | 100                      |
| Greater than 90 .....                              | 150                      |

<sup>24</sup> See, for example, "Interagency Guidance on Nontraditional Mortgage Product Risks," 71 FR 58609 (Oct. 4, 2006) and "Statement on Subprime Mortgage Lending," 72 FR 37569 (July 10, 2007).



(c) Loan-to-Value Ratio Calculation

The agencies propose that a banking organization calculate the LTV ratio on an ongoing basis as described below. The denominator of the LTV ratio, that is, the value of the property, would be equal to the lesser of the acquisition cost for the property (for a purchase transaction) or the estimate of a property's value at the origination of the exposure or, at the banking organization's option, at the time of restructuring. The estimate of value would be based on an appraisal or evaluation of the property in conformance with the agencies' appraisal regulations<sup>25</sup> and should conform to the "Interagency Appraisal and Evaluation Guidelines"<sup>26</sup> and the "Real Estate Lending Guidelines."<sup>27</sup> If a banking organization's first-lien residential mortgage exposure consists of both first and junior liens on a property, a banking organization could update the estimate of value at the origination of the junior-lien mortgage.

The numerator of the ratio, that is, the loan amount, would depend on whether the exposure is funded or unfunded, and on whether the exposure is a first-lien residential mortgage exposure or a junior-lien residential mortgage exposure. The loan amount of the funded portion of a first-lien residential mortgage exposure would be the principal amount of the exposure. The loan amount of the funded portion of a junior-lien residential mortgage exposure would be the principal amount of the exposure plus the maximum contractual amounts of all senior exposures secured by the same

residential property. Senior unfunded commitments may include negative amortization features and HELOCs.

A banking organization would be required to calculate a separate loan amount and LTV ratio for the unfunded portion of a residential mortgage exposure. The loan amount of the unfunded portion of a residential mortgage exposure would be the loan amount of the funded portion of the exposure, as described above, plus the unfunded portion of the maximum contractual amount of the commitment.

The agencies believe that a banking organization should be able to reflect the risk mitigating effects of loan-level private mortgage insurance (PMI) when calculating the LTV ratio of a residential mortgage exposure. Loan-level PMI is insurance that protects a lender in the event of borrower default up to a predetermined portion of the residential mortgage exposure and that does not have a pool-level cap that could effectively reduce coverage below the predetermined amount of the exposure. Under this proposed rule, a banking organization could reduce the loan amount of a residential mortgage exposure up to the amount covered by loan-level PMI, provided the PMI issuer is a regulated mortgage insurance company, is not an affiliate<sup>28</sup> of the banking organization, and (i) has long-term senior debt (without credit enhancement) that has an external rating that is in at least the third-highest investment grade rating category or (ii) has a claims-paying rating that is in at least the third-highest investment grade rating category. The agencies believe that pool-level PMI generally should not

be reflected in the calculation of the LTV ratio, because pool-level PMI is not structured in such a way that a banking organization can determine the LTV ratio for a mortgage loan.

*Question 12: The agencies request comment on all aspects of the proposed treatment of PMI under this framework.*

(d) Example of LTV Ratio Calculation

Assume a banking organization originates a first-lien residential mortgage exposure with a negative amortization feature; the property is valued at \$100,000; the original and outstanding principal amount of the exposure is \$81,000; and the negative amortization feature has a 10 percent cap and extends for ten years (that is, the mortgage loan balance can contractually negatively amortize to 110 percent of the original balance over the next 10 years). The funded loan amount of \$81,000 has an 81 percent LTV ratio, which is risk weighted at 50 percent (based on Table 7). The negative amortization feature is an unfunded commitment with a maximum contractual amount of \$8,100. It would receive a 50 percent CCF, resulting in an exposure amount of \$4,050. The loan amount of the unfunded portion would be \$81,000 funded amount plus the \$8,100 maximum contractual unfunded amount, resulting in an LTV of 89.1 percent. The unfunded commitment exposure amount of \$4,050 would therefore receive a 75 percent risk weight (based on Table 7). The total risk-weighted assets for the exposure would be \$43,538, as illustrated in Table 9:

TABLE 9.—EXAMPLE OF PROPOSED RISK-BASED CAPITAL CALCULATION FOR FIRST-LIEN RESIDENTIAL MORTGAGE EXPOSURES WITH NEGATIVE AMORTIZATION FEATURES

| <b>Funded Risk-Weighted Assets Calculation</b>   |          |
|--|----------|
| (1) Amount to Risk Weight .....  | \$81,000 |
| (2) Funded LTV Ratio = Funded Loan Amount / Property Value = \$81,000/\$100,000 = .....                            | 81%      |
| (3) Risk Weight based on Table 7 .....   | 50%      |
| (4) RW Assets for Funded Loan Amount = \$81,000 × .50 = .....  | \$40,500 |
| <b>Unfunded Risk-Weighted Assets Calculation</b>   |          |
| (1) Exposure Amount = Unfunded Maximum Amount × CCF = \$8,100 × .50 = .....  | \$4,050  |
| (2) Unfunded LTV Ratio = (Funded Amount + Unfunded Amount)/Property Value = (\$81,000 + \$8,100)/\$100,000 = ..... | 89.1%    |
| (3) Risk Weight based on Table 7 .....   | 75%      |
| (4) RW Assets for Unfunded Amount = \$4,050 × 0.75 .....   | \$3,038  |

<sup>25</sup> 12 CFR part 34, subpart C (OCC); 12 CFR part 208, subpart E and part 225, subpart G (Board); 12 CFR part 323 (FDIC); and 12 CFR part 564 (OTS).

<sup>26</sup> "The Comptroller's Handbook for Commercial Real Estate and Construction Lending", Appendix E (OCC); SR 94-55 (Board); FIL-74-94 (FDIC); and 12 CFR part 564 (OTS).

<sup>27</sup> 12 CFR part 34, subpart D, Appendix A (OCC); 12 CFR part 208, subpart E, Appendix C and part 225, subpart G (Board); 12 CFR part 365 (FDIC); and 12 CFR 560.100-101 (OTS).

<sup>28</sup> An affiliate of a banking organization is defined as any company that controls, is controlled by, or is under common control with, the banking

organization. A person or company controls a company if it: (i) Owns, controls, or holds the power to vote 25 percent or more of a class of voting securities of the company, or (ii) consolidates the company for financial reporting purposes.

TABLE 9.—EXAMPLE OF PROPOSED RISK-BASED CAPITAL CALCULATION FOR FIRST-LIEN RESIDENTIAL MORTGAGE EXPOSURES WITH NEGATIVE AMORTIZATION FEATURES—Continued

| Total Risk-Weighted Assets for a Loan with Negative Amortizing Features           |          |
|---|----------|
| RW Assets for Funded Amount + RW for Unfunded Amount = \$40,500 + \$3,038 = ..... | \$43,538 |

Note: The funded and unfunded amount of the loan will change over time once the loan begins to negatively amortize.

(e) Alternative LTV Ratio Calculation

The agencies are considering an alternative for calculating the LTV ratio and risk-weighted asset amount for residential mortgage exposures with unfunded commitments. This alternative is less complex but may result in different capital implications. Under the alternative, a banking organization would not calculate a separate risk-weighted asset amount for the funded and unfunded portion of the residential mortgage exposure. The alternative calculation would require only the calculation of a single LTV ratio representing a combined funded and unfunded amount when calculating the LTV ratio for a given exposure. Under the alternative, the loan amount of a first-lien residential mortgage exposure would equal the funded principal amount (or combined exposures provided there is no intervening lien) plus the exposure amount of any unfunded commitment (that is, the unfunded amount of the maximum contractual amount of any commitment multiplied by the appropriate CCF). The loan amount of a junior-lien residential mortgage exposure would equal the sum of: (i) The funded principal amount of the exposure, (ii) the exposure amount of any undrawn commitment associated with the junior-lien exposure, and (iii) the exposure amount of any senior exposure held by a third party on the date of origination of the junior-lien exposure. Where a senior exposure held by a third party includes an undrawn commitment, such as a HELOC or a negative amortization feature, the loan amount for a junior-lien residential mortgage exposure would include the maximum contractual amount of that commitment multiplied by the appropriate CCF. The denominator of the LTV ratio would be the same under both alternatives.

*Question 13: The agencies seek comment on the pros and cons associated with the two alternatives for calculating the LTV ratio.*

While the agencies believe risk weighting one-to-four family residential mortgage exposures based on the LTV ratio appropriately captures a large number of mortgage exposures with differing risk, the agencies have

considered basing the risk weight for these exposures on other parameters. Examples include using pricing information that the Home Mortgage Disclosure Act (HMDA) requires many banking organizations to report, or borrower credit scores.

*Question 14: The agencies seek industry views on any other risk-sensitive methods that could be used to segment residential mortgage exposures by risk level and solicit comment on how such alternatives might be applied.*

(8) Pre-Sold Construction Loans and Statutory Multifamily Mortgages

The general risk-based capital rules assign 50 percent and 100 percent risk weights to certain one-to-four family residential pre-sold construction loans and multifamily residential loans. The agencies adopted these provisions as a result of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 (RTCRI Act). The RTCRI Act mandates that each agency provide in its capital regulations (i) a 50 percent risk weight for certain one-to-four-family residential pre-sold construction loans and multifamily residential loans that meet specific statutory criteria in the RTCRI Act and any other underwriting criteria imposed by the agencies, and (ii) a 100 percent risk weight for one-to-four-family residential pre-sold construction loans for residences for which the purchase contract is cancelled.

Consistent with the RTCRI Act, a pre-sold construction loan would be subject to a 50 percent risk weight unless the purchase contract is cancelled. The NPR defines a pre-sold construction loan as any one-to-four family residential pre-sold construction loan for a residence meeting the requirements under section 618(a)(1) or (2) of the RTCRI Act and under 12 CFR part 3, Appendix A, section 3(a)(3)(iv) (for national banks); 12 CFR part 208, Appendix A, section III.C.3. (for state member banks); 12 CFR part 225, Appendix A, section III.C.3. (for bank holding companies); 12 CFR part 325, Appendix A, section II.C. (for state nonmember banks), and that is not 90 days or more past due or on nonaccrual; or 12 CFR 567.1 (definition of “qualifying residential construction

loan”) (for savings associations), and that is not on nonaccrual.

Also consistent with the RTCRI Act, under the NPR, a statutory multifamily mortgage would receive a 50 percent risk weight. The NPR defines statutory multifamily mortgage as any multifamily residential mortgage meeting the requirements under section 618(b)(1) of the RTCRI Act, and under 12 CFR part 3, Appendix A, section 3(a)(3)(v) (for national banks); 12 CFR part 208, Appendix A, section III.C.3. (for state member banks); 12 CFR part 225, Appendix A, section III.C.3. (for bank holding companies); 12 CFR part 325, Appendix A, section II.C.a. (for state nonmember banks); or 12 CFR 567.1 (definition of “qualifying multifamily mortgage loan”) and 12 CFR 567.6(a)(1)(iii) (for savings associations), and that is not on nonaccrual.<sup>29</sup> A multifamily mortgage that does not meet the definition of a statutory mortgage would be treated as a corporate exposure.

(9) Past Due Loans

Under the general risk-based capital rules, the risk weight of a loan generally does not change if the loan becomes past due, with the exception of certain residential mortgage loans. The New Accord provides risk weights ranging from 50 to 150 percent for loans that are more than 90 days past due, depending on the amount of specific provisions a banking organization has recorded.

Most banking organizations in the United States do not recognize specific provisions. Therefore, the treatment of past due exposures in the New Accord is not applicable for those banking organizations. Accordingly, to reflect impaired credit quality, the agencies propose to risk weight most exposures that are 90 days or more past due or on nonaccrual at 150 percent, except for past due residential mortgage exposures. A banking organization could reduce the risk weight of the exposure to reflect financial collateral or eligible guarantees.

<sup>29</sup> Under these proposed definitions, a loan that is 90 days or more past due or on nonaccrual would not qualify as a pre-sold construction loan or a statutory multifamily mortgage. These loans would be accorded the treatment described in the next section.

*Question 15: The agencies seek comment on whether, for those banking organizations that are required to maintain specific provisions, it would be appropriate to follow the New Accord treatment, that is, the risk weight would vary depending on the amount of specific provisions the banking organization has recorded.*

#### (10) Other Assets

The agencies propose to use the following risk weights, which are generally consistent with the risk weights in the general risk-based capital rules, for other exposures: (i) A banking organization could assign a zero percent risk weight to cash owned and held in all of its offices or in transit; to gold bullion held in its own vaults, or held in another depository institution's vaults on an allocated basis, to the extent gold bullion assets are offset by gold bullion liabilities; and to derivative contracts that are publicly traded on an exchange that requires the daily receipt and payment of cash-variation margin; (ii) a banking organization could assign a 20 percent risk weight to cash items in the process of collection; and (iii) a banking organization would have to apply a 100 percent risk weight to all assets not specifically assigned a different risk weight under this NPR (other than exposures that are deducted from tier 1 or tier 2 capital).

#### I. Off-Balance Sheet Items

Under the general risk-based capital rules, a banking organization generally determines the risk-based asset amount for an off-balance sheet exposure using a two-step process. The banking organization applies a CCF to the off-balance sheet amount to obtain an on-balance sheet credit equivalent amount and then applies the appropriate risk weight to that amount.

In general, the agencies propose to calculate the exposure amount of an off-balance sheet item by multiplying the off-balance sheet component, which is usually the notional amount, by the applicable CCF. The agencies also propose to retain most of the CCFs in the general risk-based capital rules.<sup>30</sup> Consistent with the New Accord, however, the agencies propose that a banking organization apply a 20 percent CCF to all commitments with an original maturity of one year or less (short-term commitments) that are not unconditionally cancelable rather than

the zero percent in the general risk-based capital rules. The agencies believe that a 20 percent CCF for these short-term commitments better reflects the risk of these exposures.

For purposes of this NPR, a commitment means any legally binding arrangement that obligates a banking organization to extend credit or to purchase assets. In this NPR, unconditionally cancelable means, with respect to a commitment, that a banking organization may, at any time, with or without cause, refuse to extend credit under the facility (to the extent permitted under applicable law). In the case of a residential mortgage exposure that is a line of credit, a banking organization is deemed able to unconditionally cancel the commitment if it can, at its option, prohibit additional extensions of credit, reduce the credit line, and terminate the commitment to the full extent permitted by applicable law.

Under this NPR, if a banking organization commits to provide a commitment on an off-balance sheet item, that is, a commitment to make a commitment, the agencies propose that a banking organization apply the lower of the two applicable CCFs. If a banking organization provides a commitment that is structured as a syndication, it would only be required to calculate the exposure amount for its pro rata share of the commitment.

There is no reference to note issuance facilities (NIFs) and revolving underwriting facilities (RUFs) in the proposed rule as the agencies are not aware that any such transactions exist in the United States.

Under the agencies' general risk-based capital rules, capital is required against any on-balance sheet exposures that arise from securities financing transactions (that is, repurchase agreements, reverse repurchase agreements, securities lending transactions, and securities borrowing transactions); for example, capital is required against the cash receivable that a banking organization generates when it borrows a security and posts cash collateral to obtain the security. A banking organization faces counterparty credit risk on securities financing transactions, however, regardless of whether the transaction generates an on-balance sheet exposure. In contrast to the general risk-based capital rules, this NPR requires a banking organization to hold risk-based capital against all securities financing transactions. Similar to other exposures, a banking organization would determine the exposure amount of a securities financing transaction and then risk

weight that amount based on the counterparty or, if applicable, collateral or guarantee.

In general, a banking organization must apply a 100 percent CCF to the off-balance sheet component of a repurchase agreement or securities lending or borrowing transaction. The off-balance sheet component of a repurchase agreement equals the sum of the current market values of all positions the banking organization has sold subject to repurchase. The off-balance sheet component of a securities lending transaction is the sum of the current market values of all positions the banking organization has lent under the transaction. For securities borrowing transactions, the off-balance sheet component is the sum of the current market values of all non-cash positions the banking organization has posted as collateral under the transaction. In certain circumstances, a banking organization may instead determine the exposure amount of the transaction as described in the collateralized transaction section of this preamble and in section 37 of the proposed rule.

#### J. OTC Derivative Contracts

##### (1) Background

Under the general risk-based capital rules for over-the-counter (OTC) derivative contracts, a banking organization must hold risk-based capital for counterparty credit risk.<sup>31</sup> To determine the capital requirement, a banking organization must first compute a credit equivalent amount for a contract and then apply to that amount a risk weight based on the obligor, counterparty, eligible guarantor, or recognized collateral. For an OTC derivative contract that is not subject to a qualifying bilateral netting contract, the credit equivalent amount is the sum of (i) the greater of the current exposure (mark-to-market value) or zero and (ii) an estimate of the potential future credit exposure (PFE). PFE is the notional principal amount of the contract multiplied by a credit conversion factor.

Under the general risk-based capital rules for OTC derivative contracts subject to a qualifying bilateral netting contract, the credit equivalent amount is calculated by adding the net current exposure of the netting contract and the sum of the estimates of PFE for the individual contracts. The net current

<sup>30</sup> The discussion of the risk-based capital treatment for off-balance sheet securitization exposures, including liquidity facilities for asset-backed commercial paper, is presented in Part IV of the proposed rule. Equity commitments are discussed in Part V of the proposed rule.

<sup>31</sup> OTS rules on the calculation of credit equivalent amounts for derivative contracts differ from the rules of the other agencies. That is, OTS rules address only interest rate and foreign exchange rate contracts and include certain other differences. Accordingly, the description of the current provisions in this preamble primarily reflects the other banking agencies' rules.

exposure is the sum of all positive and negative mark-to-market values of the individual contracts but not less than zero. A banking organization recognizes the effects of the bilateral netting contract on the gross potential future exposure of the contracts by calculating an adjusted add-on amount based on the ratio of net current exposure to gross current exposure, either on a counterparty-by-counterparty basis or on an aggregate basis.

## (2) Treatment of OTC Derivative Contracts

Consistent with the treatment in the New Accord and the general risk-based capital rules, the proposed rule defines an OTC derivative contract as a derivative contract that is not traded on an exchange that requires the daily receipt and payment of cash-variation margin. A derivative contract would be defined as a financial contract whose value is derived from the values of one or more underlying assets, reference rates, or indices of asset values or reference rates. Derivative contracts would include interest rate derivative contracts, exchange rate derivative contracts, equity derivative contracts, commodity derivative contracts, credit derivatives, and any other instrument that poses similar counterparty credit risks. The proposed rule also defines derivative contracts to include unsettled securities, commodities, and foreign exchange trades with a contractual settlement or delivery lag that is longer than the normal settlement period (which the proposed rule defines as the lesser of the market standard for the particular instrument and five business days). This includes, for example, mortgage-backed securities transactions that the GSEs conduct in the To-Be-Announced market.

The current exposure method for determining the exposure amount for single OTC derivative contracts contained in the New Accord is similar to the method in the agencies' general risk-based capital rules. The agencies propose to retain this risk-based capital treatment for OTC derivative contracts.

Under the agencies' general risk-based capital rules, a banking organization must obtain a written and well-reasoned legal opinion for each of its bilateral qualifying master netting agreements that cover OTC derivative contracts to recognize the netting benefit. In this NPR, the agencies propose that to use netting treatment for multiple OTC derivative contracts, the contracts must be subject to a qualifying master netting agreement.

In this NPR, a qualifying master netting agreement means any written,

legally enforceable bilateral netting agreement, provided that (i) the agreement creates a single legal obligation for all individual transactions covered by the agreement upon an event of default, including bankruptcy, insolvency or similar proceeding, of the counterparty; (ii) the agreement provides the banking organization the right to accelerate, terminate, and close out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default, including upon an event of bankruptcy, insolvency, or similar proceeding, of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions; (iii) the banking organization has conducted sufficient legal review to conclude with a well-founded basis (and maintain sufficient written documentation of that legal review) that the agreement meets the requirements of part (ii) of this definition and that, in the event of legal challenge (including one resulting from default, bankruptcy, insolvency, or similar proceeding), the relevant court and administrative authorities would find the agreement to be legal, valid, binding, and enforceable under the law of the relevant jurisdictions; (iv) the banking organization establishes and maintains procedures to monitor possible changes in relevant law and to ensure that the agreement continues to satisfy the requirements of the definition of a qualifying master netting agreement; and (v) the agreement does not contain a walkaway clause.

In some cases, the legal review requirement could be met by reasoned reliance on a commissioned legal opinion or an in-house counsel analysis. In other cases, for example, those involving certain new derivative transactions or derivative counterparties in atypical jurisdictions, the banking organization would need to obtain an explicit, written legal opinion from external or internal legal counsel addressing the particular situation.

If an OTC derivative contract is collateralized by financial collateral, a banking organization would first determine the exposure amount of the OTC derivative contract as described above and in section 35 of this proposed rule. To take into account the risk-reducing effects of the financial collateral, a banking organization could recognize the credit risk mitigation benefits of the financial collateral using the simple approach for collateralized transactions provided in section 37(b) of this proposed rule. Alternatively, a

banking organization could, if the financial collateral is marked-to-market on a daily basis and subject to a daily margin maintenance requirement, adjust the exposure amount of the contract using the collateral haircut approach provided in section 37(c) of this proposed rule.

## (3) Counterparty Credit Risk for Credit Derivatives

A banking organization that purchases a credit derivative that is recognized under section 36 of the proposed rule as a credit risk mitigant for an existing exposure that is not a covered position under the MRR would not have to compute a separate counterparty credit risk capital requirement for the credit derivative in section 31 of the proposed rule. If a banking organization chose not to hold risk-based capital against the counterparty credit risk of such credit derivative contracts, it would have to do so consistently for all such credit derivative contracts. Further, where the contracts are subject to a qualifying master netting agreement, the banking organization would either include them all or exclude them all from any measure used to determine counterparty credit risk exposure to all relevant counterparties for risk-based capital purposes.

Where a banking organization provides protection through a credit derivative that is not treated as a covered position under the MRR, it would treat the credit derivative as an exposure to the reference obligor and compute a risk-weighted asset amount for the credit derivative under section 31 of the proposed rule. The banking organization need not compute a counterparty credit risk capital requirement for the credit derivative, as long as it does so consistently for all such credit derivatives and either includes all or excludes all such credit derivatives that are subject to a qualifying master netting contract from any measure used to determine counterparty credit risk exposure to all relevant counterparties for risk-based capital purposes. Where the banking organization provides protection through a credit derivative treated as a covered position under the MRR, it would compute a counterparty credit risk capital requirement using an amount determined under the OTC derivative contracts section of this NPR. However, the PFE of the protection provider would be capped at the net present value of the amount of unpaid premiums.

**(4) Counterparty Credit Risk for Equity Derivatives**

Under this NPR, a banking organization would be required to treat an equity derivative contract as an equity exposure and compute a risk-weighted asset amount for that exposure. A banking organization could choose not to hold risk-based capital against the counterparty credit risk of such equity contracts unless the banking organization treats the contract as a covered position under the MRR. However, it would have to do so consistently for all such equity derivative contracts. Furthermore, where the contracts are subject to a qualifying master netting agreement, the banking organization would have to either include or exclude all the contracts from any measure used to determine counterparty credit risk exposure to all relevant counterparties for risk-based capital purposes. (The approach for equity exposures is provided in Part V of the proposed rule.)

**(5) Risk Weight for OTC Derivative Contracts**

Under the general risk-based capital rules, a banking organization must risk weight the credit equivalent amount of an OTC derivative exposure by applying the risk weight of the counterparty or, where applicable, guarantor or collateral, to the credit equivalent amount of the contract(s). The risk weight is limited to 50 percent even if the counterparty or guarantor would otherwise receive a higher risk weight.

The agencies limited the risk weight assigned to OTC derivative contracts to 50 percent when they finalized the derivatives counterparty credit risk rule in 1995.<sup>32</sup> At that time, most derivatives counterparties were highly rated and were generally financial institutions. The agencies noted, however, 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.

Consistent with the New Accord, the agencies propose that the risk weight for OTC derivative transactions would not be subject to any specific ceiling. As the market for derivatives has developed, the types of counterparties acceptable to participants have expanded to include counterparties that the agencies believe merit a risk weight greater than 50 percent.

**K. Credit Risk Mitigation (CRM)**

Banking organizations use a number of techniques to mitigate credit risks.

For example, a banking organization may collateralize exposures by first-priority claims, in whole or in part, with cash or securities; a third party may guarantee a loan exposure; or a banking organization may buy a credit derivative to offset an exposure's credit risk. Additionally, a banking organization may agree to net exposures to a counterparty against reciprocal exposures from that counterparty. This section describes how a banking organization could recognize for risk-based capital purposes the risk-mitigation effects of guarantees, credit derivatives, financial collateral, and, in limited cases, non-financial collateral.

To recognize credit risk mitigants for risk-based capital purposes, a banking organization should have in place operational procedures and risk management processes that ensure that all documentation used in collateralizing or guaranteeing a transaction is legal, valid, binding, and enforceable under applicable law in the relevant jurisdictions. The banking organization should have conducted sufficient legal review to reach a well-founded conclusion that the documentation meets this standard and should reconduct such a review as necessary to ensure continuing enforceability.

Although the use of credit risk mitigants may reduce or transfer credit risk, it simultaneously may increase other risks, including operational, liquidity, and market risks. Accordingly, it is imperative that a banking organization employ robust procedures and processes to control risks, including roll-off risk and concentration risk, arising from the banking organization's use of credit risk mitigants and to monitor the implications of using credit risk mitigants for the banking organization's overall credit risk profile.

**(1) Guarantees and Credit Derivatives****(a) Eligibility Requirements**

The agencies' general risk-based capital rules generally recognize third-party guarantees provided by central governments, U.S. 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. Consistent with the New Accord, the agencies propose to allow a banking organization to use a substitution approach similar to the approach in the agencies' general risk-based capital rules and recognize a wider range of guarantors.

This NPR defines an eligible guarantor as any of the following entities: (i) a sovereign entity, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation (Farmer Mac), an MDB, a depository institution, a foreign bank, a credit union, a bank holding company (as defined in section 2 of the Bank Holding Company Act (12 U.S.C. 1841)), or a savings and loan holding company (as defined in 12 U.S.C. 1467a) provided all or substantially all of the holding company's activities are permissible for a financial holding company under 12 U.S.C. 1843(k); or (ii) any other entity (other than a securitization special purpose entity (SPE)) if at the time the entity issued the guarantee or credit derivative or at any time thereafter, the entity has issued and has outstanding an unsecured long-term debt security without credit enhancement that has a long-term applicable external rating.

For recognition under this proposed rule, consistent with the advanced approaches final rule, guarantees and credit derivatives would have to meet specific eligibility requirements. This proposed rule defines an eligible guarantee as a guarantee from an eligible guarantor that: (i) is written; (ii) is either unconditional, or a contingent obligation of the United States Government or its agencies, the validity of which to the beneficiary is dependent upon some affirmative action on the part of the beneficiary of the guarantee or a third party (for example, servicing requirements); (iii) covers all or a pro rata portion of all contractual payments of the obligor on the reference exposure; (iv) gives the beneficiary a direct claim against the protection provider; (v) is not unilaterally cancelable by the protection provider for reasons other than the breach of the contract by the beneficiary; (vi) 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; (vii) 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 in a timely manner without the beneficiary first having to take legal actions to pursue the obligor for payment; (viii) does not increase the beneficiary's cost of credit protection on the guarantee in response to deterioration in the credit quality of the reference exposure; and (ix) is not provided by an affiliate of the

<sup>32</sup> 60 FR 46169-46185 (September 5, 1995).

banking organization, unless the affiliate is an insured depository institution, foreign bank, securities broker or dealer, or insurance company that does not control the banking organization; and is subject to consolidated supervision and regulation comparable to that imposed on U.S. depository institutions, securities brokers or dealers, or insurance companies (as the case may be).

In this NPR, consistent with the advanced approaches final rule, eligible credit derivative means a credit derivative in the form of a credit default swap,  $n^{\text{th}}$ -to-default swap, total return swap, or any other form of credit derivative approved by the primary Federal supervisor, provided that:

(i) The contract meets the requirements of an eligible guarantee and has been confirmed by the protection purchaser and the protection provider;

(ii) Any assignment of the contract has been confirmed by all relevant parties;

(iii) If the credit derivative is a credit default swap or  $n^{\text{th}}$ -to-default swap, the contract includes the following credit events: (A) failure to pay any amount due under the terms of the reference exposure, subject to any applicable minimal payment threshold that is consistent with standard market practice and with a grace period that is closely in line with the grace period of the reference exposure; and (B) bankruptcy, insolvency, or inability of the obligor on the reference exposure to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due, and similar events;

(iv) The terms and conditions dictating the manner in which the contract is to be settled are incorporated into the contract;

(v) If the contract allows for cash settlement, the contract incorporates a robust valuation process to estimate loss reliably and specifies a reasonable period for obtaining post-credit event valuations of the reference exposure;

(vi) If the contract requires the protection purchaser to transfer an exposure to the protection provider at settlement, the terms of at least one of the exposures that is permitted to be transferred under the contract must provide that any required consent to transfer may not be unreasonably withheld;

(vii) If the credit derivative is a credit default swap or  $n^{\text{th}}$ -to-default swap, the contract clearly identifies the parties responsible for determining whether a credit event has occurred, specifies that this determination is not the sole

responsibility of the protection provider, and gives the protection purchaser the right to notify the protection provider of the occurrence of a credit event; and

(viii) If the credit derivative is a total return swap and the banking organization records net payments received on the swap as net income, the banking organization records offsetting deterioration in the value of the hedged exposure (through reductions in fair value).

Under this NPR, which is consistent with the advanced approaches final rule, a banking organization would be permitted to recognize an eligible credit derivative that hedges an exposure that is different from the credit derivative's reference exposure used for determining the derivative's cash settlement value, deliverable obligation, or occurrence of a credit event only if: (i) The reference exposure ranks *pari passu* or subordinated to the hedged exposure and (ii) the reference exposure and the hedged exposure are exposures to the same legal entity, and legally enforceable cross-default or cross-acceleration clauses are in place to assure protection payments under the credit derivative are triggered when the obligor fails to pay under the terms of the hedged exposure.

#### (b) Substitution Approach

Under the substitution approach in this NPR, if the protection amount (as defined below) of the eligible guarantee or eligible credit derivative is greater than or equal to the exposure amount of the hedged exposure, a banking organization could substitute the risk weight associated with the guarantee or credit derivative for the risk weight of the hedged exposure. If the protection amount of the eligible guarantee or eligible credit derivative is less than the exposure amount of the hedged exposure, the banking organization would have to treat the hedged exposure as two separate exposures (protected and unprotected) to recognize the credit risk mitigation benefit of the guarantee or credit derivative on the protected exposure. A banking organization would calculate the risk-weighted asset amount for the protected exposure under section 36 of this NPR (using a risk weight associated with the guarantee or credit derivative and an exposure amount equal to the protection amount of the guarantee or credit derivative). The banking organization would calculate its risk-weighted asset amount for the unprotected exposure under section 36 of this NPR (using the risk weight assigned to the exposure and an exposure amount equal to the exposure

amount of the original hedged exposure minus the protection amount of the guarantee or credit derivative). If the banking organization determines that substitution of the guarantee or credit derivative's risk weight would lead to an inappropriate degree of risk mitigation, it may substitute a higher risk weight.

The protection amount of an eligible guarantee or eligible credit derivative would be the effective notional amount of the guarantee or credit derivative reduced by any applicable haircuts for maturity mismatch, lack of restructuring coverage, and currency mismatch (each described below). The effective notional amount of an eligible guarantee or eligible credit derivative would be the lesser of the contractual notional amount of the credit risk mitigant and the exposure amount of the hedged exposure, multiplied by the percentage coverage of the credit risk mitigant. For example, the effective notional amount of a guarantee that covers, on a pro rata basis, 40 percent of any losses on a \$100 bond would be \$40.

#### (c) Maturity Mismatch Haircut

A banking organization that seeks to reduce the risk-weighted asset amount of an exposure by recognizing an eligible guarantee or eligible credit derivative would have to adjust the effective notional amount of the credit risk mitigant downward to reflect any maturity mismatch between the hedged exposure and the credit risk mitigant. A maturity mismatch occurs when the residual maturity of a credit risk mitigant is less than that of the hedged exposure(s). When a banking organization has a group of hedged exposures with different residual maturities that are covered by a single eligible guarantee or eligible credit derivative, a banking organization would treat each hedged exposure as if it were fully covered by a separate eligible guarantee or eligible credit derivative. To determine whether any of the hedged exposures has a maturity mismatch with the eligible guarantee or credit derivative, the banking organization would assess whether the residual maturity of the eligible guarantee or eligible credit derivative is less than that of the hedged exposure.

The residual maturity of a hedged exposure would be the longest possible remaining time before the obligor is scheduled to fulfill its obligation on the exposure. Embedded options that may reduce the term of the credit risk mitigant would be taken into account so that the shortest possible residual maturity for the credit risk mitigant would be used to determine the

potential maturity mismatch. Where a call is at the discretion of the protection provider, the residual maturity of the eligible guarantee or eligible credit derivative would be at the first call date. If the call is at the discretion of the banking organization purchasing the protection, but the terms of the arrangement at the origination of the eligible guarantee or eligible credit derivative contain a positive incentive for the banking organization to call the transaction before contractual maturity, the remaining time to the first call date would be the residual maturity of the credit risk mitigant. For example, where there is a step-up in the cost of credit protection in conjunction with a call feature or where the effective cost of protection increases over time even if credit quality remains the same or improves, the residual maturity of the credit risk mitigant would be the remaining time to the first call.

Under the proposed rule, a banking organization would only recognize an eligible guarantee or an eligible credit derivative with a maturity mismatch if the original maturity is equal to or greater than one year and the residual maturity is greater than three months.

When a maturity mismatch exists, a banking organization would have to apply the following maturity mismatch adjustment to the effective notional amount of the guarantee or credit derivative adjusted for maturity mismatch:

$$P_m = E \times (t - 0.25) / (T - 0.25),$$

Where:

- (i)  $P_m$  = effective notional amount of the guarantee or credit derivative adjusted for maturity mismatch;
- (ii)  $E$  = effective notional amount of the guarantee or credit derivative;
- (iii)  $t$  = lesser of  $T$  or residual maturity of the guarantee or credit derivative, expressed in years; and
- (iv)  $T$  = lesser of 5 or residual maturity of the hedged exposure, expressed in years.

#### (d) Restructuring Haircut

A banking organization that seeks to recognize an eligible credit derivative that does not include a restructuring as a credit event that triggers payment under the derivative would have to reduce the recognition of the credit derivative by 40 percent. For these purposes, a restructuring involves forgiveness or postponement of principal, interest, or fees that result in a credit loss event (that is, a charge off, specific provision, or other similar debit to the profit and loss account).

In other words, the effective notional amount of the credit derivative adjusted for lack of restructuring credit event

(and maturity mismatch, if applicable) would be:

$$Pr = P_m \times 0.60,$$

Where:

- (i)  $Pr$  = effective notional amount of the credit derivative, adjusted for lack of restructuring credit event (and maturity mismatch, if applicable); and
- (ii)  $P_m$  = effective notional amount of the credit derivative (adjusted for maturity mismatch, if applicable).

#### (e) Currency Mismatch Haircut

Where the eligible guarantee or eligible credit derivative is denominated in a currency different from that in which any hedged exposure is denominated, the effective notional amount of the guarantee or credit derivative adjusted for currency mismatch (and maturity mismatch and lack of restructuring credit event, if applicable) would be calculated as:

$$P_c = Pr \times (1 - H_{fx}),$$

Where:

- (i)  $P_c$  = effective notional amount of the guarantee or credit derivative, adjusted for currency mismatch (and maturity mismatch and lack of restructuring credit event, if applicable);
- (ii)  $Pr$  = effective notional amount of the guarantee or credit derivative (adjusted for maturity mismatch and lack of restructuring credit event, if applicable); and
- (iii)  $H_{fx}$  = haircut appropriate for the currency mismatch between the guarantee or credit derivative and the hedged exposure.

Except as provided below, a banking organization would be required to use a standard supervisory haircut of 8.0 percent for  $H_{fx}$  (based on a ten-business day holding period and daily marking-to-market and remargining).

Alternatively, a banking organization could use internally estimated haircuts for  $H_{fx}$  based on a ten-business day holding period and daily marking-to-market and remargining if the banking organization qualifies to use the own-estimates haircuts, or the simple VaR method as provided in section 37(d) of this NPR. The banking organization would scale these haircuts up using the square root of time formula if the banking organization revalues the guarantee or credit derivative less frequently than once every ten business days. The applicable haircut (HM) is calculated using the following square root of time formula:

$$H_M = H_N \sqrt{\frac{T_M}{T_N}},$$

Where:

- (i)  $T_M$  = greater of ten and the number of days between revaluations of the credit derivative or guarantee;
- (ii)  $T_N$  = holding period used by the banking organization to derive  $H_N$ ; and
- (iii)  $H_N$  = haircut based on the holding period  $T_N$ .

#### (f) Multiple Credit Risk Mitigants

If multiple credit risk mitigants (for example, two eligible guarantees) cover a single exposure, the CRM section in the New Accord provides that a banking organization must disaggregate the exposure into portions covered by each credit risk mitigant (for example, the portion covered by each guarantee) and must calculate separately the risk-based capital requirement of each portion.<sup>33</sup> The New Accord also indicates that when credit risk mitigants provided by a single protection provider have differing maturities, the mitigants should be subdivided into separate layers of protection.<sup>34</sup> The agencies propose to permit a banking organization to take this approach.

#### (2) Collateralized Transactions

The general risk-based capital rules recognize limited types of collateral: Cash on deposit; securities issued or guaranteed by central governments of the OECD countries; securities issued or guaranteed by the U.S. government or its agencies; and securities issued by certain multilateral development banks.<sup>35</sup>

#### (a) Collateral Proposal

In the past, the banking industry has urged the agencies to recognize a wider array of collateral types for purposes of reducing risk-based capital requirements. The agencies agree that their general risk-based capital rules for collateral are restrictive and, in some cases, ignore market practice. Accordingly, the agencies propose to recognize the credit mitigating impact of financial collateral. For purposes of this NPR, financial collateral means collateral in the form of any of the following instruments: (i) Cash on deposit with the banking organization (including cash held for the banking organization by a third-party custodian or trustee); (ii) gold bullion; (iii) long-term debt securities that have an applicable external rating of one category below investment grade or higher (for example, at least BB-); (iv)

<sup>33</sup> New Accord, ¶ 206.

<sup>34</sup> *Id.*

<sup>35</sup> 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," 71 FR 16776 (April 4, 2006).



short-term debt instruments that have an applicable external rating of at least investment grade (for example, at least A-3); (v) equity securities that are publicly traded; (vi) convertible bonds that are publicly traded; (vii) money market mutual fund shares and other mutual fund shares if a price for the shares is publicly quoted daily; or (viii) conforming residential mortgage exposures. With the exception of cash on deposit, the banking organization would have to have a perfected, first-priority security interest in the collateral or, outside of the United States, the legal equivalent thereof, notwithstanding the prior security interest of any custodial agent. A banking organization could

recognize partial collateralization of the exposure.

The agencies propose to permit a banking organization to recognize the risk-mitigating effects of financial collateral using the simple approach, the collateral haircut approach, and the simple VaR approach. The collateral haircut and simple VaR approaches are the same as the collateral haircut and simple VaR approaches in the advanced approaches final rule. The agencies do not propose, however, to include the internal models method (for example, the expected positive exposure (EPE) method) in this NPR.

The agencies propose to permit a banking organization to use any

applicable approach to recognize collateral provided the banking organization uses the same approach for similar exposures. Under this NPR as under the advanced approaches final rule, a banking organization could use the collateral haircut approach only for repo-style transactions, eligible margin loans, collateralized OTC derivative transactions, and single-product netting sets thereof, and the simple VaR approach only for single-product netting sets of repo-style transactions and eligible margin loans.

Table 10 illustrates the CRM methods that would be available for various types of transactions under the proposed rule.

TABLE 10.—APPLICABILITY OF CRM METHODS

| Collateralized exposure       | Simple approach | Collateral haircut approach | Simple VaR method |
|-------------------------------|-----------------|-----------------------------|-------------------|
| Any exposure .....            | X               | .....                       | .....             |
| OTC Derivative Contract ..... | X               | X                           | .....             |
| Repo-Style Transaction .....  | X               | X                           | X                 |
| Eligible Margin Loan .....    | X               | X                           | X                 |

The proposed rule defines repo-style transaction as a repurchase or reverse repurchase transaction, or a securities borrowing or securities lending transaction (including a transaction in which the banking organization acts as agent for a customer and indemnifies the customer against loss), provided that:

(i) The transaction is based solely on liquid and readily marketable securities, cash, gold, or conforming residential mortgage exposures;

(ii) The transaction is marked-to-market daily and subject to daily margin maintenance requirements;

(iii)(a) The transaction is a “securities contract” or “repurchase agreement” under section 555 or 559, respectively, of the Bankruptcy Code (11 U.S.C. 555 or 559), a qualified financial contract under section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)), or a netting contract between or among financial institutions under sections 401–407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401–4407) or the Federal Reserve Board’s Regulation EE (12 CFR part 231); or (b) if the transaction does not meet the criteria in paragraph (iii)(a) of this definition, then: Either the transaction is executed under an agreement that provides the banking organization the right to accelerate, terminate, and close out the transaction on a net basis and to liquidate or set off collateral promptly upon an event of

default (including upon an event of bankruptcy, insolvency, or similar proceeding) of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions; or the transaction is either overnight or unconditionally cancelable at any time by the banking organization and is executed under an agreement that provides the banking organization the right to accelerate, terminate, and close out the transaction on a net basis and to liquidate or set off collateral promptly upon an event of counterparty default; and

(iv) The banking organization has conducted sufficient legal review to conclude with a well-founded basis (and maintains sufficient documentation of that legal review) that the agreement meets the requirements of paragraph (iii) of this definition and is legal, valid, binding, and enforceable under applicable law in the relevant jurisdictions.

This NPR defines an eligible margin loan as an extension of credit where: (i) the extension of credit is collateralized exclusively by liquid and readily marketable debt or equity securities, gold, or conforming residential mortgage exposures; (ii) the collateral is marked-to-market daily, and the transaction is subject to daily margin maintenance requirements; (iii) the extension of credit is conducted under an agreement that provides the banking organization

the right to accelerate and terminate the extension of credit and to liquidate or set off collateral promptly upon an event of default (including upon an event of bankruptcy, insolvency, or similar proceeding) of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions;<sup>36</sup> and (iv) the banking organization has conducted sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review) that the agreement meets the requirements of paragraph (iii) of this definition and is legal, valid, binding, and enforceable under applicable law in the relevant jurisdictions.

(b) Risk Management Guidance for Recognizing Collateral

Before relying on the CRM benefits of collateral to risk weight its exposures, a banking organization should: (i) Conduct sufficient legal review to ensure, at inception and on an ongoing basis, that all documentation used in the

<sup>36</sup> This requirement is met where all transactions under the agreement are (i) executed under U.S. law and (ii) constitute “securities contracts” under section 555 of the Bankruptcy code (11 U.S.C. 555), qualified financial contracts under section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)), or netting contracts between or among financial institutions under sections 401–407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401–4407) or the Federal Reserve Board’s Regulation EE (12 CFR part 231).

collateralized transaction is binding on all parties and legally enforceable in all relevant jurisdictions; (ii) consider the correlation between obligor risk of the underlying direct exposure and collateral risk in the transaction; and (iii) fully take into account the time and cost needed to realize the liquidation proceeds and the potential for a decline in collateral value over this time period.

A banking organization also should ensure that: (i) the legal mechanism under which the collateral is pledged or transferred ensures that the banking organization has the right to liquidate or take legal possession of the collateral in a timely manner in the event of the default, insolvency, or bankruptcy (or other defined credit event) of the obligor and, where applicable, the custodian holding the collateral; (ii) the banking organization has taken all steps necessary to fulfill legal requirements to secure its interest in the collateral so that it has and maintains an enforceable security interest; (iii) the banking organization has clear and robust procedures to ensure observation of any legal conditions required for declaring the default of the borrower and prompt liquidation of the collateral in the event of default; (iv) the banking organization has established procedures and practices for conservatively estimating, on a regular ongoing basis, the market value of the collateral, taking into account factors that could affect that value (for example, the liquidity of the market for the collateral and obsolescence or deterioration of the collateral); and (v) the banking organization has in place systems for promptly requesting and receiving additional collateral for transactions whose terms require maintenance of collateral values at specified thresholds.

#### (c) Simple Approach

The agencies propose to allow a banking organization to apply the simple approach, which is similar to the approach in the agencies' general risk-based capital rules, in a manner generally consistent with the New Accord. Generally, under the simple approach, the collateralized portion of the exposure would receive the risk weight applicable to the collateral. Subject to certain exceptions, the risk weight assigned to the collateralized portion of the exposure may not be less than 20 percent. In most cases, the collateral would have to be financial collateral. For repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions, the collateral is the instruments, gold, and cash the banking organization has borrowed, purchased

subject to resale, or taken as collateral from the counterparty under the transaction. A banking organization, however, could recognize any collateral for a repo-style transaction that is included in the banking organization's VaR-based measure under the MRR. In all cases, the collateral agreement would have to be for at least the life of the exposure, a banking organization would have to revalue the collateral at least every six months, and the exposure and the collateral (other than gold) would have to be denominated in the same currency.

In certain cases, collateral may be used to reduce the risk weight to less than 20 percent for an exposure. The exceptions to the risk-weight floor of 20 percent are: (i) OTC derivative transactions that are marked-to-market on a daily basis and subject to a daily margin maintenance agreement, which could receive (1) a zero percent risk weight to the extent that they are collateralized by cash on deposit, and (2) a 10 percent risk weight to the extent that they are collateralized by a sovereign security or PSE security that qualifies for a zero percent risk weight under section 33 of this NPR; (ii) the portion of exposures collateralized by cash on deposit could receive a zero percent risk weight; and (iii) the portion of exposures collateralized by a sovereign security or a PSE security denominated in the same currency could receive a zero percent risk weight provided that the banking organization discounts the market value of the collateral by 20 percent.

In the case where a banking organization chooses to recognize collateral in the form of conforming residential mortgages, the banking organization must risk weight the portion of the exposure that is secured by the conforming residential mortgage at 50 percent.

#### (d) Collateral Haircut and Simple VaR Approaches

The agencies propose to permit a banking organization to use the collateral haircut approach to recognize the risk mitigating effect of financial collateral that secures a repo-style transaction, eligible margin loan, collateralized OTC derivative contract, or single-product netting set of such transactions through an adjustment to the exposure amount. The collateral haircut approach contains two methods for calculating the haircuts: Supervisory haircuts or own-estimates haircuts. Additionally, the banking organization could use the simple VaR approach for single-product netting sets of repo-style transactions or eligible margin loans. In

this proposed rule, a netting set means a group of transactions with a single counterparty that are subject to a qualifying master netting agreement.

Although a banking organization could use any combination of supervisory haircuts, own-estimate haircuts, and simple VaR (only for single-product netting sets of repo-style transactions or eligible margin loans) to recognize collateral, it would have to use the same approach for similar exposures. A banking organization could, however, apply a different method to subsets of repo-style transactions, eligible margin loans, or OTC derivatives by product type or geographic location if its application of different methods were designed to separate transactions that do not have similar risk profiles and was not designed for arbitrage purposes. For example, a banking organization could choose to use one method for agency securities lending transactions, that is, repo-style transactions in which the banking organization, acting as agent for a customer, lends the customer's securities and indemnifies the customer against loss, and another method for all other repo-style transactions. The agencies propose to require use of the supervisory haircut approach to recognize the risk-mitigating effect of conforming residential mortgages in exposure amount. Use of the standard supervisory haircut approach for repo-style transactions, eligible margin loans, and OTC derivatives collateralized by conforming mortgages, however, would not preclude a banking organization's use of own estimates haircuts or the simple VaR approach for exposures collateralized by other types of financial collateral.

Consistent with the New Accord and the advanced approaches final rule, a banking organization could also use the collateral haircut approaches to recognize the benefits of any collateral (not only financial collateral) mitigating the counterparty credit risk of repo-style transactions included in a banking organization's VaR-based measure under the MRR. In this instance, a banking organization would not need to apply the supervisory haircut approach to conforming mortgage collateral, but could use one of the other approaches to recognize that collateral.

#### (e) Exposure Amount for Repo-Style Transactions, Eligible Margin Loans, and Collateralized OTC Derivatives

Under the collateral haircut approach, a banking organization would set the exposure amount equal to the greater of zero and the sum of three quantities:

(i) The value of the exposure less the value of the collateral (for eligible margin loans and repo-style transactions, the value of the exposure is the sum of the current market values of all instruments, gold, and cash the banking organization has lent, sold subject to repurchase, or posted as collateral to the counterparty under the transaction (or netting set); for collateralized OTC derivative contracts, the value of the exposure is the exposure amount that is calculated under section 35(c) or (d) of this proposed rule; the value of the collateral is the sum of the current market values of all instruments, gold and cash the banking organization has borrowed, purchased subject to resale, or taken as collateral from the counterparty under the transaction (or netting set));

(ii) The absolute value of the net position in a given instrument or in gold (where the net position in a given instrument or in gold equals the sum of the current market values of the instrument or gold the banking organization has lent, sold subject to repurchase, or posted as collateral to the counterparty minus the sum of the current market values of that same instrument or gold the banking organization has borrowed, purchased subject to resale, or taken as collateral from the counterparty) multiplied by the

market price volatility haircut appropriate to the instrument or gold; and

(iii) The sum of the absolute values of the net position of any cash or instruments in each currency that is different from the settlement currency multiplied by the haircut appropriate to each currency mismatch.

To determine the appropriate haircuts, a banking organization may choose to use standard supervisory haircuts or, with prior written approval from its primary Federal supervisor, its own estimates of haircuts. After determining the exposure amount, the banking organization would risk weight the exposure amount according to the obligor or guarantor if applicable.

For purposes of the collateral haircut approach, a given instrument would include, for example, all securities with a single Committee on Uniform Securities Identification Procedures (CUSIP) number and would not include securities with different CUSIP numbers, even if issued by the same issuer with the same maturity date.

For purposes of this calculation, the net position in a given currency equals the sum of the current market values of any instruments or cash in the currency the banking organization has lent, sold subject to repurchase, or posted as collateral to the counterparty minus the

sum of the current market values of any instruments or cash in the currency the banking organization has borrowed, purchased subject to resale, or taken as collateral from the counterparty.

(f) Standard Supervisory Haircuts

Under this NPR, if a banking organization chooses to use standard supervisory haircuts, it would use an 8.0 percent haircut for each currency mismatch and use the market price volatility haircut appropriate to each security in Table 11 below. These haircuts are based on the ten-business-day holding period for eligible margin loans and collateralized OTC derivative contracts and may be multiplied by the square root of 1/2 to convert the standard supervisory haircuts to the five-business-day minimum holding period for repo-style transactions (unless the collateral is conforming residential mortgages, in which case the banking organization must use a minimum ten-business-day holding period). A banking organization would adjust the standard supervisory haircuts upward on the basis of a holding period longer than ten business days for eligible margin loans and collateralized OTC derivative contracts or five business days for repo-style transactions where and as appropriate to take into account the illiquidity of an instrument.

TABLE 11.—STANDARD SUPERVISORY HAIRCUTS BASED ON MARKET PRICE VOLATILITY <sup>1</sup>

| Applicable external rating grade category for debt securities   | Residual maturity for debt securities | Sovereign entity issuers <sup>2</sup>  | Other issuers |
|---|---------------------------------------|--|---------------|
| Two highest investment grade rating categories for long-term ratings/highest investment grade rating category for short-term ratings. | ≤ 1 year .....                        | .005   | .01           |
|   | >1 year, ≤ 5 years .....              | .02  | .04           |
|   | >5 years .....                        | .04  | .08           |
| Two lowest investment grade rating categories for both short- and long-term ratings.  | ≤ 1 year .....                        | .01  | .02           |
|   | >1 year, ≤ 5 years .....              | .03  | .06           |
|   | > 5 years .....                       | .06  | .12           |
| One rating category below investment grade .....  | All .....                             | .15  | .25           |
| Main index equities <sup>37</sup> (including convertible bonds) and gold .....  |                                       | .15  | .15           |
| Other publicly traded equities (including convertible bonds), conforming residential mortgages, and non-financial collateral.         |                                       | .25  | .25           |
| Mutual funds .....  |                                       | (1) Highest haircut applicable to any security in which the fund can invest. |               |
| Cash on deposit with the bank (including a certificate of deposit issued by the banking organization) .....                           |                                       | 0  | 0             |

<sup>1</sup> The market price volatility haircuts in Table 11 are based on a ten-business-day holding period.

<sup>2</sup> This column includes the haircuts for MDBs and foreign PSEs that would receive a zero percent risk weight.

As an example, if a banking organization that uses standard

<sup>37</sup> The proposed rule defines a “main index” as the S&P 500 Index, the FTSE All-World Index, and any other index for which the bank demonstrates to the satisfaction of its primary Federal supervisor that the equities represented in the index have

supervisory haircuts has extended an eligible margin loan of \$100 that is collateralized by five-year U.S. Treasury

comparable liquidity, depth of market, and size of bid-ask spreads as equities in the S&P 500 Index and the FTSE All-World Index.

notes with a market value of \$100, the value of the exposure less the value of the collateral would be zero, and the net position in the security (\$100) times the supervisory haircut (.02) would be \$2. There is no currency mismatch.

Therefore, the exposure amount would be \$0 + \$2 = \$2.

(g) Own Estimates of Haircuts

With the prior written approval of the banking organization's primary Federal supervisor, a banking organization could calculate market price volatility and currency mismatch haircuts using its own internal estimates of market price volatility and foreign exchange volatility. The banking organization's primary Federal supervisor would base approval to use internally estimated haircuts on the satisfaction of certain minimum qualitative and quantitative standards. These standards include: (i) The banking organization would use a 99th percentile one-tailed confidence interval and a minimum five-business-day holding period for repo-style transactions and a minimum ten-business-day holding period for all other transactions; (ii) the banking organization would adjust holding periods upward where and as appropriate to take into account the illiquidity of an instrument; (iii) the banking organization would select a historical observation period for calculating haircuts of at least one year; and (iv) the banking organization would update its data sets and compute haircuts no less frequently than quarterly and would update its data sets and compute haircuts whenever market prices change materially. A banking organization would estimate individually the volatilities of the exposure, the collateral, and foreign exchange rates and may not take into account the correlations between them.

A banking organization that uses internally estimated haircuts would have to adhere to the following rules. The banking organization could calculate internally estimated haircuts for categories of debt securities that have an applicable external or applicable inferred rating of at least investment grade. The haircut for a category of securities would have to be representative of the internal volatility estimates for securities in that category that the banking organization has actually lent, sold subject to repurchase, posted as collateral, borrowed, purchased subject to resale, or taken as collateral. In determining relevant categories, the banking organization would at a minimum have to take into account (i) the type of issuer of the security; (ii) the applicable external rating of the security; (iii) the maturity of the security; and (iv) the interest rate sensitivity of the security. A banking organization would calculate a separate internally estimated haircut for each individual debt security that has an

applicable external rating below investment grade and for each individual equity security. In addition, a banking organization would estimate a separate currency mismatch haircut for its net position in each mismatched currency based on estimated volatilities for foreign exchange rates between the mismatched currency and the settlement currency where an exposure or collateral (whether in the form of cash or securities) is denominated in a currency that differs from the settlement currency.

When a banking organization calculates an internally estimated haircut on a  $T_N$ -day holding period, which is different from the minimum holding period for the transaction type, the banking organization would have to calculate the applicable haircut ( $H_M$ ) using the following square root of time formula:

$$H_M = H_N \sqrt{\frac{T_M}{T_N}}$$

Where:

- (i)  $T_M$  = five for repo-style transactions and ten for eligible margin loans and OTC derivatives;
- (ii)  $T_N$  = holding period used by the banking organization to derive  $H_N$ ; and
- (iii)  $H_N$  = haircut based on the holding period  $T_N$ .

(h) Simple VaR Method

With the prior written approval of its primary Federal supervisor, a banking organization could estimate the exposure amount for repo-style transactions and eligible margin loans subject to a single-product qualifying master netting agreement using a VaR model. Under the simple VaR method, a banking organization's exposure amount for transactions subject to such a netting agreement would be equal to the value of the exposures minus the value of the collateral plus a VaR-based estimate of the PFE. The value of the exposures would be the sum of the current market values of all instruments, gold, and cash the banking organization has lent, sold subject to repurchase, or posted as collateral to a counterparty under the netting set. The value of the collateral would be the sum of the current market values of all instruments, gold, and cash the banking organization has borrowed, purchased subject to resale, or taken as collateral from a counterparty under the netting set. The VaR-based estimate of the PFE would be an estimate of the banking organization's maximum exposure on the netting set over a fixed time horizon with a high level of confidence.

To qualify for the simple VaR approach, a banking organization's VaR model would have to estimate the banking organization's 99th percentile, one-tailed confidence interval for an increase in the value of the exposures minus the value of the collateral ( $\Sigma E - \Sigma C$ ) over a five-business-day holding period for repo-style transactions or over a ten-business-day holding period for eligible margin loans using a minimum one-year historical observation period of price data representing the instruments that the banking organization has lent, sold subject to repurchase, posted as collateral, borrowed, purchased subject to resale, or taken as collateral. The main ongoing qualification requirement for using a VaR model is that the banking organization would have to validate its VaR model by establishing and maintaining a rigorous and regular backtesting regime. In this NPR, backtesting means the comparison of a banking organization's internal estimates with actual outcomes during a sample period not used in model development.

(i) Zero H Approach

The New Accord includes an additional approach, the Zero H approach, to recognize the risk mitigating benefits of certain collateral types in repo-style transactions conducted with a limited group of counterparties. The Zero H approach permits a banking organization that uses the collateral haircut approach to apply a haircut of zero percent to financial collateral in repo-style transactions that meet the criteria described below and are conducted with core market participants. Under the New Accord, the definition of core market participants includes sovereign entities, central banks, PSEs, banks and securities firms, other financial companies eligible for a 20 percent risk weight, regulated mutual funds, regulated pension funds, and recognized clearing organizations. A repo-style transaction conducted with a core market participant qualifies for the Zero H approach if: (i) Both the exposure and the collateral are cash or a sovereign or PSE security that qualifies for a zero percent risk weight and are denominated in the same currency; (ii) following a counterparty's failure to remargin, the time required between the last mark-to-market before the failure to remargin and the liquidation<sup>38</sup> of the collateral is no more than four business days; (iii) the

<sup>38</sup> The banking organization does not have to liquidate the collateral, but it would have to be able to do so within the time frame.

transaction is settled across a settlement system proven for that type of transaction; (iv) the documentation covering the agreement is standard market documentation for repo-style transactions in the securities concerned; (v) the transaction is governed by documentation specifying that if the counterparty fails to satisfy an obligation to deliver cash or securities or to deliver margin or otherwise defaults, then the transaction is immediately terminable; and (vi) upon any default event, regardless of whether the counterparty is insolvent or bankrupt, the banking organization has the unfettered, legally enforceable right to immediately seize and liquidate the collateral for its benefit.

The New Accord also includes a variation of the Zero H approach for banking organizations that use the simple approach to recognize financial collateral. For repo-style transactions that meet the Zero H criteria and are conducted with core market participants, the banking organization would assign a risk weight of zero percent. A banking organization would assign a risk weight of 10 percent to repo-style transaction exposures that meet the criteria and are conducted with non-core market participants.

The agencies have decided not to include the Zero H approach and the variation for the simple approach in this proposal because the agencies believe that doing so would add unnecessary complexity. In the New Accord, a banking organization must choose to use either the simple approach or the comprehensive approach<sup>39</sup> for all its collateralized transactions. The agencies have proposed a more flexible treatment that would permit a banking organization to select its approach to collateral based on transaction type. This flexibility allows for more risk sensitivity in the capital calculation for repo-style transactions. For example, a banking organization could choose the collateral haircut or simple VaR approach for repo-style transactions and the simple approach for other transaction types. Additionally, the agencies question whether the capital requirements prescribed by the Zero H approach adequately address the credit risk of repo-style transactions. In both this proposal and the New Accord, banking organizations would be subject to the operational risk capital requirement for these transactions.

*Question 16: The agencies seek comment on whether these Zero H approaches should be included in the standardized framework. Additionally, the agencies seek comment on whether the Zero H approaches would adequately address the credit risk of repo-style transactions that would qualify for those approaches.*

(j) Internal Models Methodology

The advanced approaches final rule includes an internal models methodology for the calculation of the exposure amount for the counterparty credit exposure for OTC derivatives, eligible margin loans, and repo-style transactions. This methodology requires a risk model that captures counterparty credit risk and estimates the exposure amount at the level of a netting set. A banking organization may use the internal models methodology for OTC derivatives, eligible margin loans, and repo-style transactions.

The internal models methodology is fully discussed in the advanced approaches final rule.<sup>40</sup> The specific references in the advanced approaches final rule's preamble and common rule text are: (i) Preamble;<sup>41</sup> (ii) section 22(c) and certain other paragraphs in section 22 of the common rule text,<sup>42</sup> such as paragraphs (a)(2) and (3), (i), (j), and (k), which discuss the qualification requirements for the advanced systems in general and therefore would apply to the expected positive exposure modeling approach (EPE) as part of the internal models methodology; (iii) section 32(c) and (d) of the common rule text;<sup>43</sup> (iv) applicable definitions in Section 2 of the common rule text;<sup>44</sup> and (v) applicable disclosure requirements in Tables 11.6 and 11.7 of the common rule text.<sup>45</sup>

Although the internal models methodology is not part of this proposed rule, the standardized approach in the New Accord does incorporate an internal models methodology for credit risk mitigants. Therefore, the agencies are considering whether to implement the internal models methodology in a final rule consistent with the requirements in the advanced approaches final rule.

*Question 17: The agencies request comment on the appropriateness of including the internal models methodology for calculating exposure amounts for OTC derivatives, eligible*

*margin loans, and repo-style transactions in any final rule implementing the standardized framework. The agencies also requested comment on the extent to which banking organizations contemplating implementing the standardized framework believe they can meet the associated advanced modeling and systems requirements. (For purposes of reviewing the internal models methodology in the advanced approaches final rule, commenters should substitute the term "exposure amount" for the term "exposure at default" and "EAD" each time these terms appear in the advanced approaches final rule.)*

L. Unsettled Transactions

Consistent with the New Accord and the advanced approaches final rule, the agencies propose to institute a more risk-sensitive risk-based capital requirement for unsettled and failed securities, foreign exchange, and commodities transactions.

The proposed capital requirement, however, would not apply to certain transaction types, including:

(i) Transactions accepted by a qualifying central counterparty<sup>46</sup> that are subject to daily marking-to-market and daily receipt and payment of variation margin (which do not have a risk-based capital requirement);

(ii) Repo-style transactions;

(iii) One-way cash payments on OTC derivative contracts; and

(iv) Transactions with a contractual settlement period that is longer than the normal settlement period as defined below. (Such transactions would be treated as OTC derivative contracts and assessed a risk-based capital requirement under section 31 of the proposed rule.) This proposed rule also provides that, in the case of a system-wide failure of a settlement or clearing system, the banking organization's primary Federal supervisor could waive risk-based capital requirements for unsettled and failed transactions until the situation is rectified.

This NPR contains separate treatments for delivery-versus-payment

<sup>46</sup> Qualifying central counterparty would be defined as a counterparty that: (i) Facilitates trades between counterparties in one or more financial markets by either guaranteeing trades or novating contracts; (ii) requires all participants in its arrangements to be fully collateralized on a daily basis; and (iii) the banking organization demonstrates to the satisfaction of the agency is in sound financial condition and is subject to effective oversight by a national supervisory authority. The agencies consider a qualifying central counterparty to be the functional equivalent of an exchange and have long exempted exchange-traded contracts from risk-based capital requirements.

<sup>40</sup> See 72 FR 69288 (December 7, 2007).

<sup>41</sup> Id. at 69346–49 and 69302–21.

<sup>42</sup> Id. at 69407–08.

<sup>43</sup> Id. at 69413–16.

<sup>44</sup> Id. at 69397–405.

<sup>45</sup> Id. at 69443.

<sup>39</sup> The comprehensive approach in the New Accord includes the collateral haircut approaches, the simple VaR approach, and the internal models approach.

(DvP) and payment-versus-payment (PvP) transactions with a normal settlement period, and non-DvP/non-PvP transactions with a normal settlement period. This NPR provides the following definitions of a DvP transaction, a PvP transaction, and a normal settlement period:

- A DvP transaction is a securities or commodities transaction in which the buyer is obligated to make payment only if the seller has made delivery of the securities or commodities and the seller is obligated to deliver the securities or commodities only if the buyer has made payment.

- A PvP transaction is a foreign exchange transaction in which each counterparty is obligated to make a final transfer of one or more currencies only if the other counterparty has made a final transfer of one or more currencies.

- A transaction has a normal settlement period if the contractual settlement period for the transaction is equal to or less than the market standard for the instrument underlying the transaction and equal to or less than five business days.

A banking organization would have to hold risk-based capital against a DvP or PvP transaction with a normal settlement period if the banking organization's counterparty has not made delivery or payment within five business days after the settlement date. The banking organization would determine its risk-weighted asset amount for such a transaction by multiplying the positive current exposure of the transaction for the banking organization by the appropriate risk weight in Table 12. The positive current exposure of a transaction of a banking organization would be the difference between the transaction value at the agreed settlement price and the current market price of the transaction, if the difference results in a credit exposure of the banking organization to the counterparty.

TABLE 12.—RISK WEIGHTS FOR UNSETTLED DVP AND PVP TRANSACTIONS

| Number of business days after contractual settlement date | Risk weight to be applied to positive current exposure (in percent) |
|---|---|
| From 5 to 15 .....  | 100.0   |
| From 16 to 30 .....                                       | 625.0   |
| From 31 to 45 .....                                       | 937.5   |
| 46 or more .....  | 1,250.0   |

A banking organization would hold risk-based capital against any non-DvP/non-PvP transaction with a normal

settlement period if the banking organization delivered cash, securities, commodities, or currencies to its counterparty but has not received its corresponding deliverables by the end of the same business day. The banking organization would continue to hold risk-based capital against the transaction until the banking organization received its corresponding deliverables. From the business day after the banking organization made its delivery until five business days after the counterparty delivery is due, the banking organization would calculate its risk-based capital requirement for the transaction by risk weighting the current market value of the deliverables owed to the banking organization using the risk weight appropriate for an exposure to the counterparty.

If, in a non-DvP/non-PvP transaction with a normal settlement period, the banking organization has not received its deliverables by the fifth business day after the counterparty delivery due date, the banking organization would deduct the current market value of the deliverables owed to the banking organization 50 percent from tier 1 capital and 50 percent from tier 2 capital.

*M. Risk-Weighted Assets for Securitization Exposures*

Under the agencies' general risk-based capital rules, a banking organization may use external ratings issued by NRSROs to assign risk weights to certain recourse obligations, residual interests, direct credit substitutes, and asset- and mortgage-backed securities. Exposures to securitization transactions may also be subject to capital requirements that can result in effective risk weights of 1,250 percent, or a dollar-for-dollar capital requirement. A banking organization must deduct certain CEIOs from tier 1 capital.<sup>47</sup>

(1) Securitization Overview and Definitions

The securitization framework in this NPR is designed to address the credit risk of exposures that involve the tranching of the credit risk of one or more underlying financial exposures. The agencies believe that requiring all or substantially all of the underlying exposures for a securitization to be financial exposures creates an important boundary between the general credit risk framework and the securitization framework. Examples of financial exposures are loans, commitments,

receivables, asset-backed securities, mortgage-backed securities, other debt securities, equity securities, or credit derivatives. Based on their cash flow characteristics, for purposes of this proposal, the agencies would also consider asset classes such as lease residuals and entertainment royalties to be financial assets. The securitization framework is designed to address the tranching of the credit risk of financial exposures and is not designed, for example, to apply to tranching of credit exposures to commercial or industrial companies or nonfinancial assets. Accordingly, under this NPR, a specialized loan to finance the construction or acquisition of large-scale projects (for example, airports or power plants), objects (for example, ships, aircraft, or satellites), or commodities (for example, reserves, inventories, precious metals, oil, or natural gas) generally would not be a securitization exposure because the assets backing the loan typically are nonfinancial assets (the facility, object, or commodity being financed).

Consistent with the advanced approaches final rule, this NPR would define a securitization exposure as an on-balance sheet or off-balance sheet credit exposure that arises from a traditional or synthetic securitization (including credit-enhancing representations and warranties). A traditional securitization means a transaction in which: (i) All or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties other than through the use of credit derivatives or guarantees; (ii) the credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority; (iii) the performance of the securitization exposures depends upon the performance of the underlying exposures; (iv) all or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities); (v) the underlying exposures are not owned by an operating company; (vi) the underlying exposures are not owned by a small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682); and (vii) (a) for banks and bank holding companies, the underlying exposures are not owned by a firm an investment in which qualifies as a community development investment under 12 U.S.C. 24 (Eleventh); or (b) for

<sup>47</sup> 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.1 (FDIC); and 12 CFR 567.6(b) (OTS).

savings associations, the underlying exposures are not owned by a firm an investment in which is designed primarily to promote community welfare, including the welfare of low- and moderate-income communities or families, such as by providing services or employment.

In this proposed rule, operating companies would not fall under the definition of a traditional securitization (even if substantially all of their assets are financial exposures). For purposes of this proposed rule's definition of a traditional securitization, operating companies generally are companies that produce goods or provide services beyond the business of investing, reinvesting, holding, or trading in financial assets. Examples of operating companies are depository institutions, bank holding companies, securities brokers and dealers, insurance companies, and non-bank mortgage lenders. Accordingly, an equity investment in an operating company, such as a bank, generally would be an equity exposure under the proposed rule. Investment firms, which generally do not produce goods or provide services beyond the business of investing, reinvesting, holding, or trading in financial assets, would not be operating companies for purposes of this proposed rule and would not qualify for this general exclusion from the definition of traditional securitization. Examples of investment firms would include companies that are exempted from the definition of an investment company under section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)) by either section 3(c)(1) (15 U.S.C. 80a-3(c)(1)) or section 3(c)(7) (15 U.S.C. 80a-3(c)(7)) of the Act.

Under this proposed rule, a primary Federal supervisor of a banking organization would have the discretion to exclude from the definition of traditional securitization transactions in which the underlying exposures are owned by investment firms that exercise substantially unfettered control over the size and composition of their assets, liabilities, and off-balance sheet transactions. The agencies would consider a number of factors in the exercise of this discretion, including the assessment of the investment firm's leverage, risk profile, and economic substance. This supervisory exclusion would give the primary Federal supervisor the discretion to distinguish structured finance transactions, to which the securitization framework was designed to apply, from those of flexible investment firms such as many hedge funds and private equity funds. Only investment firms that can easily change

the size and composition of their capital structure, as well as the size and composition of their assets and off-balance sheet exposures, would be eligible for the exclusion from the definition of traditional securitization under this provision. The agencies do not consider managed collateralized debt obligation vehicles, structured investment vehicles, and similar structures, which allow considerable management discretion regarding asset composition but are subject to substantial restrictions regarding capital structure, to have substantially unfettered control. Thus, such transactions would meet the definition of traditional securitization.

The agencies are concerned that the line between securitization exposures and non-securitization exposures may be difficult to draw in some circumstances. In addition to the supervisory exclusion from the definition of traditional securitization described above, a primary Federal supervisor may scope certain transactions into the securitization framework if justified by the economics of the transaction. Similar to the analysis for excluding an investment firm from treatment as a traditional securitization, the agencies would consider the economic substance, leverage, and risk profile of transactions to ensure that the appropriate risk-based capital classification is made. The agencies would consider a number of factors when assessing the economic substance of a transaction including, for example, the amount of equity in the structure, overall leverage (whether on- or off-balance sheet), whether redemption rights attach to the equity investor, and the ability of the junior tranches to absorb losses without interrupting contractual payments to more senior tranches.

A synthetic securitization means a transaction in which: (i) All or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties through the use of one or more credit derivatives or guarantees (other than a guarantee that transfers only the credit risk of an individual retail exposure); (ii) the credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority; (iii) performance of the securitization exposures depends upon the performance of the underlying exposures; and (iv) all or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed

securities, mortgage-backed securities, other debt securities, or equity securities).

Both the designation of exposures as securitization exposures and the calculation of risk-based capital requirements for securitization exposures would be guided by the economic substance of a transaction rather than its legal form. Provided there is a tranching of credit risk, securitization exposures could include, among other things, asset-backed and mortgage-backed securities, loans, lines of credit, liquidity facilities, financial standby letters of credit, credit derivatives and guarantees, loan servicing assets, servicer cash advance facilities, reserve accounts, credit-enhancing representations and warranties, and CEIOs. Securitization exposures also could include assets sold with retained tranches. Mortgage-backed pass-through securities, for example, those guaranteed by Fannie Mae or Freddie Mac, do not meet the proposed definition of securitization exposure because they do not involve a tranching of credit risk. Rather, only those mortgage-backed securities that involve tranching of credit risk would be securitization exposures. Banking organizations are encouraged to consult with their primary Federal supervisor about transactions that require additional guidance.

## (2) Operational Requirements

### (a) Operational Requirements for Traditional Securitizations

In a traditional securitization, an originating banking organization typically transfers a portion of the credit risk of exposures to third parties by selling them to a securitization special purpose entity (SPE). Under this NPR, a banking organization would be an originating banking organization if it: (i) Directly or indirectly originated or securitized the underlying exposures included in the securitization; or (ii) serves as an asset-backed commercial paper (ABCP) program sponsor to the securitization. Under the proposed rule, a banking organization that engages in a traditional securitization would exclude the underlying exposures from the calculation of risk-weighted assets only if each of the following conditions are met: (i) the transfer is a sale under GAAP; (ii) the originating banking organization transfers to one or more third parties credit risk associated with the underlying exposures; and (iii) any clean-up calls relating to the securitization are eligible clean-up calls (as discussed below). An originating banking organization that meets these



conditions would hold regulatory capital against any securitization exposures it retains in connection with the securitization. An originating banking organization that fails to meet these conditions would instead hold regulatory capital against the transferred exposures as if they had not been securitized and would deduct from tier 1 capital any after-tax gain-on-sale resulting from the transaction.

Consistent with the general risk-based capital rules, the above operational requirements refer specifically to GAAP for the purpose of determining whether a securitization transaction should be treated as an asset sale or a financing. In contrast, the New Accord stipulates guiding principles for determining whether sale treatment is warranted. The agencies believe that the conditions currently outlined under GAAP to qualify for sale treatment are broadly consistent with the guiding principles enumerated in the New Accord. However, if GAAP in this area were to materially change, the agencies would reassess, and possibly revise, the operational standards.

#### (b) Clean-Up Calls

To satisfy the operational requirements for securitizations and enable an originating banking organization to exclude the underlying exposures from the calculation of its risk-based capital requirements, any clean-up call associated with a securitization must be an eligible clean-up call. The proposed rule defines a clean-up call as a contractual provision that permits an originating banking organization or servicer to call securitization exposures (for example, asset-backed securities) before the stated maturity or call date. In the case of a traditional securitization, a clean-up call is generally accomplished by repurchasing the remaining securitization exposures once the amount of underlying exposures or outstanding securitization exposures falls below a specified level. In the case of a synthetic securitization, the clean-up call may take the form of a clause that extinguishes the credit protection once the amount of underlying exposures has fallen below a specified level.

Under the proposed rule, an eligible clean-up call is a clean-up call that:

- (i) Is exercisable solely at the discretion of the originating banking organization or servicer;
- (ii) Is not structured to avoid allocating losses to securitization exposures held by investors or otherwise structured to provide credit enhancement to the securitization (for

example, to purchase non-performing underlying exposures); and

(iii)(a) For a traditional securitization, is only exercisable when 10 percent or less of the principal amount of the underlying exposures or securitization exposures (determined as of the inception of the securitization) is outstanding; or

(b) For a synthetic securitization, is only exercisable when 10 percent or less of the principal amount of the reference portfolio of underlying exposures (determined as of the inception of the securitization) is outstanding.

Where a securitization SPE is structured as a master trust, a clean-up call with respect to a particular series or tranche issued by the master trust would meet criteria (iii)(a) and (iii)(b) as long as the outstanding principal amount in that series was 10 percent or less of its original amount at the inception of the series.

#### (c) Operational Requirements for Synthetic Securitizations

In general, the proposed rule's treatment of synthetic securitizations is similar to that of traditional securitizations. The operational requirements for synthetic securitizations, however, are more rigorous to ensure that the originating banking organization has truly transferred credit risk of the underlying exposures to one or more third-party protection providers.

For synthetic securitizations, an originating banking organization would recognize the use of credit risk mitigation to hedge, or transfer credit risk associated with, underlying exposures for risk-based capital purposes only if each of the following conditions were satisfied:

(i) The credit risk mitigant is financial collateral, an eligible credit derivative, or an eligible guarantee.

(ii) The banking organization transfers credit risk associated with the underlying exposures to one or more third parties, and the terms and conditions in the credit risk mitigants do not include provisions that:

(a) Allow for the termination of the credit protection due to deterioration in the credit quality of the underlying exposures;

(b) Require the banking organization to alter or replace the underlying exposures to improve the credit quality of the underlying exposures;

(c) Increase the banking organization's cost of credit protection in response to deterioration in the credit quality of the underlying exposures;

(d) Increase the yield payable to parties other than the banking

organization in response to a deterioration in the credit quality of the underlying exposures; or

(e) Provide for increases in a retained first loss position or credit enhancement provided by the banking organization after the inception of the securitization.

(iii) The banking organization obtains a well-reasoned opinion from legal counsel that confirms the enforceability of the credit risk mitigant in all relevant jurisdictions.

(iv) Any clean-up calls relating to the securitization are eligible clean-up calls (as discussed above).

Failure to meet the above operational requirements for a synthetic securitization would prevent the originating banking organization from using this securitization framework and would require the originating banking organization to hold risk-based capital against the underlying exposures as if they had not been synthetically securitized. A banking organization that provides credit protection to a synthetic securitization would use the securitization framework to compute risk-based capital requirements for its exposures to the synthetic securitization even if the originating banking organization failed to meet one or more of the operational requirements for a synthetic securitization.

#### (3) Hierarchy of Approaches

Under the proposed rule a banking organization generally would determine the amount of a traditional or synthetic securitization exposure and then determine the risk-based capital requirement for the securitization exposure according to two general approaches: A ratings-based approach (RBA) and an approach for exposures that do not qualify for the RBA. Although synthetic securitizations typically employ credit derivatives, a banking organization must first apply the securitization framework when calculating risk-based capital requirements for a synthetic securitization exposure. Under this proposed rule, a banking organization could ultimately be redirected to the securitization CRM rules to adjust the securitization framework capital requirement for an exposure to reflect the CRM technique used in the transaction.

#### (a) Exposure Amount of a Securitization Exposure

Under this proposed rule, the amount of an on-balance sheet securitization exposure that is not a repo-style transaction, eligible margin loan, or OTC derivative contract (other than a credit derivative) would be the banking

organization's carrying value minus any unrealized gains and plus any unrealized losses on the exposure if the exposure were a security classified as available-for-sale, or the banking organization's carrying value if the exposure were not a security classified as available-for-sale.

The amount of an off-balance sheet securitization exposure that is not an eligible ABCP liquidity facility, a repo-style transaction, or an OTC derivative contract (other than a credit derivative) would be the notional amount of the exposure.

This NPR defines an eligible ABCP liquidity facility as 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 or exposures 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 with an applicable external rating of at least investment grade at the time of funding. Notwithstanding these eligibility requirements, a liquidity facility will be considered an eligible ABCP liquidity facility if the assets or exposures funded under the liquidity facility and that do not meet the eligibility requirements are guaranteed, either conditionally or unconditionally, by a sovereign entity with an issuer rating in one of the three highest investment grade rating categories.

Consistent with the New Accord, the exposure amount of an eligible ABCP liquidity facility would be the notional amount of the exposure multiplied by (i) a 20 percent CCF, for a facility with an original maturity of one year or less that does not qualify for the RBA; (ii) a 50 percent CCF, for a facility with an original maturity of over one year that does not qualify for the RBA; or (iii) 100 percent, for a facility that qualifies for the RBA. The proposed CCF for eligible ABCP liquidity facilities with an original maturity of less than one year is greater than the 10 percent CCF prescribed under the general risk-based capital rules. The agencies believe the credit risk of eligible ABCP liquidity facilities is similar to that of other short-term commitments to lend or purchase assets, and believe that a 20 percent CCF is appropriate for both eligible ABCP liquidity facilities and non-securitization commitments with an original maturity of one year or less.

Under this proposed rule, when a securitization exposure to an ABCP program is a commitment, such as a

liquidity facility, the notional amount could be reduced to the maximum potential amount that the banking organization could be required to fund given the ABCP program's current underlying assets (calculated without regard to the current credit quality of those assets). Thus, if \$100 is the maximum amount that could be drawn given the current volume and current credit quality of the program's assets, but the maximum potential draw against these same assets could increase to as much as \$200 under some scenarios if their credit quality were to deteriorate, then the exposure amount is \$200.

The amount of securitization exposure that is a repo-style transaction, eligible margin loan, or an OTC derivative (other than a credit derivative) would be the exposure amount as calculated in section 35 or 37 of this proposed rule.

#### (b) Gains-on-Sale and CEIOs

Under the proposed rule, a banking organization would first deduct from tier 1 capital any after-tax gain-on-sale resulting from a securitization and would deduct from total capital any portion of a CEIO that does not constitute an after-tax gain-on-sale, as described in section 21 of the proposed rule. Thus, if the after-tax gain-on-sale associated with a securitization equaled \$100 while the amount of CEIOs associated with that same securitization equaled \$120, the banking organization would deduct \$100 from tier 1 capital and \$20 from total capital (\$10 from tier 1 capital and \$10 from tier 2 capital). The agencies believe these deductions are appropriate given historical supervisory concerns with the subjectivity involved in valuations of gains-on-sale and CEIOs. Furthermore, although the treatments of gains-on-sale and CEIOs can increase an originating banking organization's risk-based capital requirement following a securitization, the agencies believe that such anomalies will be rare where a securitization transfers significant credit risk from the originating banking organization to third parties.

#### (c) Ratings-Based Approach

If a securitization exposure is not a gain-on-sale or CEIO, a banking organization would apply the RBA to a securitization exposure if the exposure qualifies for the RBA.<sup>48</sup> Generally, an exposure would qualify for the RBA if the exposure has an external rating from an NRSRO or has an inferred rating (that

is, the exposure is senior to another securitization exposure in the transaction that has an external rating from an NRSRO).

#### (d) Securitization Exposures That Do Not Qualify for the RBA

If a securitization exposure is not a gain-on-sale or CEIO and does not qualify for the RBA, a banking organization generally would be required to deduct the exposure from total capital. However, there are several situations in the approach for unrated exposures described below and in section 44 of the proposed rule in which an alternative risk-based capital treatment is permitted.

#### (e) Exceptions to the General Hierarchy of Approaches

There are four exceptions to the general approach described above that parallel the agencies' general risk-based capital rules. First, an interest-only mortgage-backed security would be assigned a risk weight that is no less than 100 percent. The agencies believe that a minimum risk weight of 100 percent is prudent in light of the uncertainty implied by the substantial price volatility of these securities. Second, a sponsoring banking organization that qualifies as a primary beneficiary and must consolidate an ABCP program as a variable interest entity under GAAP could exclude the consolidated ABCP program assets from risk-weighted assets.<sup>49</sup> In such cases, the banking organization would hold risk-based capital against any of its securitization exposures to the ABCP program. Third, as required by Federal statute, a special set of rules would continue to apply to transfers of small-business loans and leases with recourse by well-capitalized depository institutions.<sup>50</sup> Finally, under this NPR, if a securitization exposure is an OTC derivative contract (other than a credit derivative) that has a first priority claim on the cash flows from the underlying exposures (notwithstanding amounts due under interest rate or currency derivative contracts, fees due, or other similar payments), a banking organization may choose to apply an

<sup>49</sup> See Financial Accounting Standards Board, "Interpretation No. 46(R): Consolidation of Certain Variable Interest Entities" (December 2003).

<sup>50</sup> See 12 U.S.C. 1835, which places a cap on the risk-based capital requirement applicable to a well-capitalized depository institution that transfers small-business loans with recourse. The final rule does not expressly state that the agencies may permit adequately capitalized banks to use the small business recourse rule on a case-by-case basis because the agencies may do this under the general reservation of authority contained in section 1 of the rule.

<sup>48</sup> A securitization exposure held by an originating bank must have two or more external ratings or inferred ratings to qualify for the RBA.

effective 100 percent risk weight to the exposure rather than the general securitization hierarchy of approaches. This treatment would be subject to supervisory approval.

(f) Overlapping Exposures

This proposal also includes provisions to limit the double counting of risks in situations involving overlapping securitization exposures. If a banking organization has multiple securitization exposures that provide duplicative coverage to the underlying exposures of a securitization (such as when a banking organization provides a program-wide credit enhancement and multiple pool-specific liquidity facilities to an ABCP program), the banking organization is not required to hold duplicative risk-based capital against the overlapping position. Instead, the banking organization would apply to the overlapping position the applicable risk-based capital treatment under the securitization framework that results in the highest capital requirement. If different banking organizations have overlapping exposures to a securitization, however, each banking organization would hold capital against the entire maximum amount of its exposure. Although duplication of capital requirements will not occur for an individual banking organization, some systemic duplication would occur where multiple banking organizations have overlapping exposures to the same securitization.

(g) Servicer Cash Advances

A traditional securitization typically employs a servicing banking organization that, on a day-to-day basis, collects principal, interest, and other payments from the underlying exposures of the securitization and forwards such payments to the securitization SPE or to investors in the securitization. Such servicing banking organizations often provide a credit facility to the securitization under which the servicing banking organization could advance cash to ensure an uninterrupted flow of payments to investors in the securitization (including advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the underlying exposures). These servicer cash advance facilities are securitization exposures.

Under the proposed rule, a servicing banking organization would determine

its risk-based capital requirement for any advances under such a facility using either the RBA or the approach for securitization exposures that do not qualify for the RBA as described below. The treatment of the undrawn portion of the facility would depend on whether the facility is an "eligible" servicer cash advance facility. An eligible servicer cash advance facility would be defined as a servicer cash advance facility in which: (i) The servicer is entitled to full reimbursement of advances (except that a servicer could be obligated to make non-reimbursable advances for a particular underlying exposure if any such advance is contractually limited to an insignificant amount of the outstanding principal balance of that exposure); (ii) the servicer's right to reimbursement is senior in right of payment to all other claims on the cash flows from the underlying exposures of the securitization; and (iii) the servicer has no legal obligation to, and does not, make advances to the securitization if the servicer concludes the advances are unlikely to be repaid. Consistent with the general risk-based capital rules with respect to residential mortgage servicer cash advances, a servicing banking organization would not be required to hold risk-based capital against the undrawn portion of an eligible servicer cash advance facility. A banking organization that provides a non-eligible servicer cash advance facility would determine its risk-based capital requirement for the undrawn portion of the facility in the same manner as the banking organization would determine its risk-based capital requirement for any other off-balance sheet securitization exposure.

(h) Implicit Support

The proposed rule also specifies the regulatory capital consequence if a banking organization provides support to a securitization in excess of the banking organization's predetermined contractual obligation. First, consistent with the general risk-based capital rules, a banking organization that provides such implicit support would have to hold regulatory capital against all of the underlying exposures associated with the securitization as if the exposures had not been securitized, and would deduct from tier 1 capital any after-tax gain-on-sale resulting from the

securitization.<sup>51</sup> Second, the banking organization would have to disclose publicly (i) that it has provided implicit support to the securitization, and (ii) the regulatory capital impact to the banking organization of providing the implicit support. The banking organization's primary Federal supervisor also could require the banking organization to hold regulatory capital against all the underlying exposures associated with some or all of the banking organization's other securitizations as if the exposures had not been securitized, and to deduct from tier 1 capital any after-tax gain-on-sale resulting from such securitizations.

Over the last several years, the agencies have published a significant amount of supervisory guidance to assist banking organizations with the capital treatment of securitization exposures. In general, the agencies expect banking organizations to continue to use this guidance, most of which would remain applicable to the standardized securitization framework.

(4) Ratings-Based Approach

Under this NPR, a banking organization would determine the risk-weighted asset amount for a securitization exposure that is eligible for the RBA by multiplying the exposure amount by the appropriate risk weight provided in Table 13 or Table 14. Banking organizations would deduct from total capital exposures that have applicable long-term ratings of two categories or more below investment grade and applicable short-term ratings below the lowest investment grade rating.

Under the proposal, whether a securitization exposure is eligible for the RBA would depend on whether the banking organization holding the securitization exposure is an originating banking organization or an investing banking organization. An originating banking organization would be required to use the RBA for a securitization exposure if (i) the exposure has two or more external ratings, or (ii) the exposure has two or more external or inferred ratings. In contrast, an investing banking organization would be required to use the RBA for a securitization exposure if the exposure has one or more external or inferred ratings.

<sup>51</sup> "Interagency Guidance on Implicit Recourse in Asset Securitizations," May 23, 2002. OCC Bulletin 2002-20 (OCC); SR02-15 (Board); FIL-52-2002 (FDIC); and CEO Memo No. 162 (OTS).

TABLE 13.—LONG-TERM CREDIT RATING RISK WEIGHTS UNDER THE RBA

| Applicable external rating or applicable inferred rating of a securitization exposure | Example   | Risk weight (in percent) |
|---|-----------|--------------------------|
| Highest investment grade rating .....   | AAA ..... | 20.                      |
| Second-highest investment grade rating .....  | AA .....  | 20.                      |
| Third-highest investment grade rating .....   | A .....   | 50.                      |
| Lowest investment grade rating .....  | BBB ..... | 100.                     |
| One category below investment grade .....   | BB .....  | 350.                     |
| Two categories below investment grade .....   | B .....   | Deduction.               |
| Three categories or more below investment grade .....                                 | CCC ..... | Deduction.               |

TABLE 14.—SHORT-TERM CREDIT RATING RISK WEIGHTS UNDER THE RBA

| Applicable external or applicable inferred rating of a securitization exposure | Example       | Risk weight (in percent) |
|--|---------------|--------------------------|
| Highest investment grade rating .....  | A-1/P-1 ..... | 20.                      |
| Second-highest investment grade rating .....                                   | A-2/P-2 ..... | 50.                      |
| Lowest investment grade rating .....   | A-3/P-3 ..... | 100.                     |
| All other ratings .....  | N/A .....     | Deduction.               |

Under the proposed rule, securitization exposures with an inferred rating are treated the same as securitization exposures with an identical external rating. However, the proposed rule includes a different provision for determining inferred ratings for securitization exposures than for other types of exposures. A securitization exposure that does not have an external rating (an unrated securitization exposure) would have an inferred rating equal to the external rating of a securitization exposure that is issued by the same issuer and secured by the same underlying exposures and (i) has an external rating; (ii) is subordinate in all respects to the unrated securitization exposure; (iii) does not benefit from any credit enhancement that is not available to the unrated securitization exposure; (iv) has an effective remaining maturity that is equal to or longer than the unrated securitization exposure; and (v) is the most immediately subordinated exposure to the unrated securitization exposure that meets the criteria in (i) through (iv) above. For example, a securitization might issue three tranches of securities designated as senior, mezzanine, and subordinated. If the senior tranche is unrated, the mezzanine tranche is rated A and meets the criteria in (i) through (iv) above, and the subordinated tranche is rated BB, the senior tranche could receive an inferred rating of A based on the rating of the mezzanine tranche, regardless of the rating of the subordinated tranche. If the mezzanine tranche has two ratings, the senior tranche could receive an applicable inferred rating based only on the lowest of the ratings on the mezzanine tranche. If a securitization

exposure has multiple inferred ratings, the applicable inferred rating is the lowest inferred rating.

Banking organizations would not be permitted to assign an inferred rating based on the ratings of the underlying exposures in a securitization, even when the unrated securitization exposure is secured by a single, externally rated security. Such an approach would fail to meet the requirements that the rated reference exposure be issued by the same issuer, secured by the same underlying assets, and subordinated in all respects to the unrated securitization exposure.

(5) Exposures That Do Not Qualify for the RBA

A banking organization would generally be required to deduct from total capital securitization exposures that do not qualify for the RBA, with the following exceptions that apply provided that the banking organization knows the composition of the underlying exposures at all times: (i) Eligible ABCP liquidity facilities, (ii) first priority securitization exposures, and (iii) exposures in a second loss position or better to an ABCP program.

(a) Eligible ABCP Liquidity Facilities

In this NPR, consistent with the New Accord, the exposure amount of an eligible ABCP liquidity facility would be assigned to the highest risk weight applicable to any of the underlying individual exposures covered by the liquidity facility.

(b) First-Priority Securitization Exposures

If a first-priority securitization exposure does not qualify for the RBA, a banking organization could determine

the risk weight of the exposure by “looking through” the exposure to its underlying assets. The risk-weighted asset amount would be the weighted-average risk weight of the underlying exposures multiplied by the exposure amount of the first-priority securitization exposure. If a banking organization is unable to determine the risk weights of the underlying credit risk exposures, the first-priority securitization exposure would be deducted from total capital.

First-priority securitization exposure would be defined as a securitization exposure that has a first-priority claim on the cash flows from the underlying exposures and that is not an eligible ABCP liquidity facility. When determining whether a securitization exposure has a first-priority claim on the cash flows from the underlying exposures, a banking organization would not be required to consider amounts due under interest rate or currency derivative contracts, fees due, or other similar payments. Generally, only the most senior tranche of a securitization would be a first-priority securitization exposure.

(c) Securitization Exposures in a Second Loss Position or Better to an ABCP Program

This NPR would define an ABCP program as a program that primarily issues commercial paper that has an external rating and is backed by underlying exposures held in a bankruptcy-remote securitization SPE. In this NPR, a banking organization would not be required to deduct from total capital a securitization exposure to an ABCP program that does not qualify for the RBA and is not an eligible ABCP

liquidity facility or a first-priority securitization exposure, provided that it satisfies the following requirements: (i) The exposure must be economically in a second loss position or better and the first loss position must provide significant credit protection to the second loss position, (ii) the credit risk associated with the exposure must be the equivalent of investment grade or better,<sup>52</sup> and (iii) the banking organization holding the exposure must not retain or provide the first loss position.

If the exposure meets the above requirements, the risk weight would be the higher of 100 percent or the highest risk weight assigned to any of the individual exposures covered by the ABCP program. The agencies believe that this approach, which is consistent with the New Accord, appropriately and conservatively assesses the credit risk of non-first loss exposures to ABCP programs.

Under the agencies' general risk-based capital rules, certain securitization exposures that are not rated by an NRSRO may be risk weighted based on alternative methods. These methods include internal risk ratings for ABCP programs, program ratings, and computer program ratings and are not included in this NPR.

*Question 18: The agencies solicit comment on the decision not to include internal risk ratings for ABCP programs, program ratings, and computer program ratings in this proposal.*

#### (6) CRM for Securitization Exposures

The proposed treatment of CRM for securitization exposures differs slightly from the CRM treatment of other exposures. An originating banking organization that has obtained a credit risk mitigant to hedge its securitization exposure to a synthetic or traditional securitization that satisfies the operational criteria in section 41 of the proposed rule could recognize the credit risk mitigant, but only as provided in section 45. An investing banking organization that has obtained a credit risk mitigant to hedge a securitization exposure also could recognize the credit

risk mitigant, but only as provided in section 45.

In general, to recognize the risk mitigating effects of financial collateral or an eligible guarantee or an eligible credit derivative for a securitization exposure, a banking organization could use the approaches for collateralized transactions or the substitution treatment for guarantees and credit derivatives described in section 36. However, section 45 of the proposed rule contains specific provisions a banking organization would have to follow when applying those approaches to securitization exposures.

In this NPR, a banking organization that determines its risk-based capital requirement for a securitization exposure based on external or inferred rating(s) that reflect the benefits of a particular credit risk mitigant provided to the associated securitization or that supports some or all of the underlying exposures, could not use the credit risk mitigation rules to further reduce its risk-based capital requirement for the exposure based on the credit risk mitigant. For example, a banking organization that owns an AAA-rated asset-backed security that benefits, along with all the other securities issued by the securitization SPE, from an insurance wrap that is part of the securitization transaction would calculate its risk-based capital requirement for the security strictly using the RBA. No additional credit would be given for the presence of the insurance wrap. In contrast, if a banking organization owns a BBB-rated asset-backed security and obtains a credit default swap from a AAA-rated counterparty to protect the banking organization from losses on the security, the banking organization would be able to apply the securitization CRM rules to recognize the risk mitigating effects of the credit default swap and determine the risk-based capital requirement for the position.

For purposes of this section, a banking organization may only recognize an eligible guarantee or eligible credit derivative from an eligible guarantor if the guarantor: (i) Is a sovereign entity, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, a Federal Home Loan Bank, Farmer Mac, an MDB, a depository institution, a foreign bank, a credit union, a bank holding company, or a savings and loan holding company; or (ii) has issued and has outstanding an unsecured long-term debt security without credit enhancement that has a long-term applicable external rating in

one of the three highest investment grade rating categories.

With respect to eligible guarantees and credit derivatives, in the context of a synthetic securitization, when an eligible guarantee or eligible credit derivative covers multiple hedged exposures that have different residual maturities, the banking organization must use the longest residual maturity of any of the hedged exposures as the residual maturity of all the hedged exposures.

#### (a) Nth-to-Default Credit Derivatives

Credit derivatives that provide credit protection only for the nth defaulting reference exposure in a group of reference exposures (nth-to-default credit derivatives) are similar to synthetic securitizations that provide credit protection only after the first-loss tranche has defaulted or become a loss. A simplified treatment would be available to banking organizations that purchase and provide such credit protection. A banking organization that obtains credit protection on a group of underlying exposures through a first-to-default credit derivative would determine its risk-based capital requirement for the underlying exposures as if the banking organization had synthetically securitized only the underlying exposure with the lowest capital requirement and had obtained no credit risk mitigant on the other (higher capital requirement) underlying exposures. If the banking organization purchased credit protection on a group of underlying exposures through an nth-to-default credit derivative (other than a first-to-default credit derivative), it would only recognize the credit protection for risk-based capital purposes either if it had obtained credit protection on the same underlying exposures in the form of first-through-(n-1)-to-default credit derivatives, or if n-1 of the underlying exposures have already defaulted. In such a case, the banking organization would determine its risk-based capital requirement for the underlying exposures as if the banking organization had only synthetically securitized the n-1 underlying exposures with the lowest capital requirement and had obtained no credit risk mitigant on the other underlying exposures.

A banking organization that provides credit protection on a group of underlying exposures through a first-to-default credit derivative would determine its risk-weighted asset amount for the derivative by applying the risk weights in Table 13 or 14 (if the derivative qualifies for the RBA) or, by setting its risk-weighted asset amount

<sup>52</sup> Interagency guidance on assessing whether a banking organization's internal risk rating system used in measuring risk exposures in ABCP programs is adequate and reasonably corresponds to the NRSRO's rating categories is set forth in "Interagency Guidance on assisting in the determination of the appropriate risk-based capital treatment to be applied to direct credit substitutes issued in connection with asset-backed commercial paper programs." March 31, 2005. OCC Bulletin 2005-12 (OCC); SR 05-6 (Board); FIL-26-2005 (FDIC); and CEO Letter #217, dated April 1, 2005 (OTS).

for the derivative equal to the product of (i) the protection amount of the derivative; and (ii) the sum of the risk weights of the individual underlying exposures, up to a maximum of 1,250 percent.

If a banking organization provides credit protection on a group of underlying exposures through an nth-to-default credit derivative (other than a first-to-default credit derivative), the banking organization would determine its risk-weighted asset amount for the derivative by applying the risk weights in Table 13 or 14 (if the derivative qualifies for the RBA) or, by setting the risk-weighted asset amount for the derivative equal to the product of (i) the protection amount of the derivative and (ii) the sum of the risk weights of the individual underlying exposures (excluding the n-1 underlying exposures with the lowest risk-based capital requirements), up to a maximum of 1,250 percent.

For example, a banking organization provides credit protection in the form of a second-to-default credit derivative on a basket of five reference exposures. The derivative is unrated and the protection amount of the derivative is \$100. The risk weights for the underlying exposures are 20 percent, 50 percent, 100 percent, 100 percent, and 150 percent. The risk-weighted asset amount of the derivative would be  $\$100 \times (50\% + 100\% + 100\% + 150\%)$  or \$400. If the derivative were externally rated one category below investment grade, the risk-weighted asset amount would be  $\$100 \times 350\%$  or \$350.

#### (7) Risk-Weighted Assets for Early Amortization Provisions

Many securitizations of revolving credit facilities (for example, credit card receivables) contain provisions that require the securitization to wind down and repay investors if the excess spread falls below a certain threshold.<sup>53</sup> This decrease in excess spread may, in some cases, be caused by deterioration in the credit quality of the underlying exposures. An early amortization event can increase a banking organization's capital needs if the banking organization would have to finance new draws on the revolving credit facilities with on-balance sheet sources of funding. The payment allocations a banking

organization uses to distribute principal and finance charge collections during the amortization phase of these transactions also can expose it to greater risk of loss than in other securitization transactions. Consistent with the New Accord, this NPR includes a risk-based capital requirement that, in general, is linked to the likelihood of an early amortization event to address the risks that early amortization of a securitization poses to originating banking organizations.

The proposed rule defines an early amortization as a provision in a securitization's governing documentation that, when triggered, causes investors in the securitization exposures to be repaid before the original stated maturity of the securitization exposure, unless the provision is triggered solely by events not related to the performance of the underlying exposures or the originating banking organization (for example, material changes in tax laws or regulations) or leaves investors exposed to future draws by obligors on the underlying exposures even after the provision is triggered.

Under the NPR, an originating banking organization would hold regulatory capital against its own interest and the investors' interest in a securitization that (i) includes one or more underlying exposures in which the borrower is permitted to vary the drawn amount within an agreed line of credit, and (ii) contains an early amortization provision. Investors' interest means, with respect to a securitization, the exposure amount of the underlying exposures multiplied by the ratio of (i) the total amount of securitization exposures issued by the securitization special purpose entity (SPE); divided by (ii) the outstanding principal amount of the underlying exposures. A banking organization would compute the risk-weighted asset amount for its interest using the hierarchy of approaches for securitization exposures described above. An originating banking organization would calculate the risk-weighted asset amount for the investors' interest in the securitization as the product of (i) the investors' interest, (ii) the appropriate conversion factor (CF), (iii) the weighted-average risk weight that would apply under this NPR to the underlying exposure type if the underlying exposures had not been securitized, and (iv) the proportion of the underlying exposures in which the borrower is permitted to vary the drawn amount within an agreed limit under a line of credit.

The CF would differ according to whether the securitized exposures are

revolving retail credit facilities (for example, credit card receivables) or other revolving credit facilities (for example, revolving corporate credit facilities) and whether the early amortization provision is controlled or non-controlled; and whether the line is committed or uncommitted. A line would qualify as uncommitted if it were unconditionally cancelable to the extent permitted under applicable law.

#### (a) Controlled Early Amortization

Under the proposed rule, a controlled early amortization provision would have to meet each of the following conditions: (i) The originating banking organization has appropriate policies and procedures to ensure that it has sufficient capital and liquidity available in the event of an early amortization; (ii) throughout the duration of the securitization (including the early amortization period) there is the same pro rata sharing of interest, principal, expenses, losses, fees, recoveries, and other cash flows from the underlying exposures, based on the originating banking organizations' and the investors' relative shares of the underlying exposures outstanding measured on a consistent monthly basis; (iii) the amortization period is sufficient for at least 90 percent of the total underlying exposures outstanding at the beginning of the early amortization period to have been repaid or recognized as in default; and (iv) the schedule for repayment of investor principal is not more rapid than would be allowed by straight-line amortization over an 18-month period. An early amortization provision that does not meet any of the above criteria would be a "non-controlled" early amortization provision.

To calculate the appropriate CF for a securitization of uncommitted revolving retail exposures that contains a controlled early amortization provision, a banking organization would compare the three-month average annualized excess spread for the securitization to the point at which the banking organization has to trap excess spread under the securitization transaction. In securitizations that do not require trapping of excess spread, or that specify a trapping point based primarily on performance measures other than the three-month average annualized excess spread, the excess spread trapping point would be 4.5 percent. The banking organization would divide the three-month average excess spread level by the excess spread trapping point and apply the appropriate CF from Table 15.

A banking organization would apply a 90 percent CF for all other revolving

<sup>53</sup> The NPR defines excess spread for a period as gross finance charge collections (including market interchange fees) and other income received by the SPE over the period minus interest paid to holders of securitization exposures, servicing fees, charge-offs, and other senior trust similar expenses of the SPE over the period, all divided by the principal balance of the underlying exposures at the end of the period.

underlying exposures (that is, committed exposures and non-retail exposures) in securitizations with a controlled early amortization provision. The proposed CFs for uncommitted revolving retail credit lines are much lower than for committed retail credit lines or for non-retail credit lines

because banking organizations have demonstrated the ability to monitor and, when appropriate, to curtail uncommitted retail credit lines promptly when a customer's credit quality deteriorates. Such account management tools are unavailable for committed lines, and banking

organizations may be less proactive about using such tools in the case of uncommitted non-retail credit lines owing to lender liability concerns and the prominence of broad-based, longer-term customer relationships.

TABLE 15.—CONVERSION FACTORS FOR CONTROLLED EARLY AMORTIZATION

| 3-month average excess spread                            | Uncommitted CF (in percent) | Committed CF (in percent) |
|--|-----------------------------|---------------------------|
| <b>Retail Credit Lines:</b>                              |                             |                           |
| Greater than or equal to 133.33% of trapping point ..... | 0                           | 90                        |
| Less than 133.33% to 100% of trapping point .....        | 1                           | .....                     |
| Less than 100% to 75% of trapping point .....            | 2                           | .....                     |
| Less than 75% to 50% of trapping point .....             | 10                          | .....                     |
| Less than 50% to 25% of trapping point .....             | 20                          | .....                     |
| Less than 25% of trapping point .....                    | 40                          | .....                     |
| <b>Non-retail credit lines .....</b>                     | <b>90</b>                   | <b>90</b>                 |

(b) Non-Controlled Early Amortization

To calculate the appropriate CF for securitizations of uncommitted revolving retail exposures that contain a non-controlled early amortization provision, a banking organization would have to perform the excess spread calculations described in the controlled early amortization section above and then apply the CFs in Table 16.

A banking organization would use a 100 percent CF for all other revolving

underlying exposures (that is, committed exposures and non-retail exposures) in securitizations with a non-controlled early amortization provision. In other words, no risk transference would be recognized for these transactions.

Where a securitization contains a mix of retail and non-retail exposures or a mix of committed and uncommitted exposures, a banking organization could take a pro-rata approach to determining

the risk-based capital requirement for the securitization's early amortization provision. If a pro-rata approach were not feasible, a banking organization would treat a securitization with an underlying exposure that is non-retail as a securitization of non-retail exposures and would treat the securitization as a securitization of committed exposures if a single underlying exposure is a committed exposure.

TABLE 16.—CONVERSION FACTORS FOR NON-CONTROLLED EARLY AMORTIZATION

| 3-month average excess spread                            | Uncommitted CF (in percent) | Committed CF (in percent) |
|--|-----------------------------|---------------------------|
| <b>Retail Credit Lines:</b>                              |                             |                           |
| Greater than or equal to 133.33% of trapping point ..... | 0                           | 100                       |
| Less than 133.33% to 100% of trapping point .....        | 5                           | .....                     |
| Less than 100% to 75% of trapping point .....            | 15                          | .....                     |
| Less than 75% to 50% of trapping point .....             | 50                          | .....                     |
| Less than 50% of trapping point .....                    | 100                         | .....                     |
| <b>Non-retail credit lines .....</b>                     | <b>100</b>                  | <b>100</b>                |

(c) Revolving Residential Mortgage Exposures

Unlike credit card securitizations, HELOC securitizations in the United States typically do not generate material excess spread and typically are structured with credit enhancements and early amortization triggers based on other factors, such as portfolio loss rates. Under the New Accord, a banking organization would have to hold capital against the potential early amortization of most U.S. HELOC securitizations at their inception, rather than only if the credit quality of the underlying exposures deteriorated. Although the securitization framework in the New

Accord does not provide an alternative methodology in such cases, the agencies have concluded that the features of the U.S. HELOC securitization market would warrant an alternative approach. Accordingly, the proposed rule allows a banking organization the option of applying either (i) the CFs in Tables 15 and 16, as appropriate, or (ii) a fixed CF of 10 percent to its securitizations for which all or substantially all of the underlying exposures are revolving residential mortgage exposures. If a banking organization chooses the fixed CF of 10 percent, it would have to use that CF for all securitizations for which all or substantially all of the underlying

exposures are revolving residential mortgage exposures.

(8) Maximum Capital Requirement

The total capital requirement for a banking organization's exposures to a single securitization with an early amortization provision is subject to a maximum capital requirement equal to the greater of (i) the capital requirement for the retained securitization exposures or (ii) the capital requirement for the underlying exposures that would apply if the banking organization directly held the underlying exposures on its balance sheet.



## N. Equity Exposures

### (1) Introduction and Exposure Measurement

Under the FDIC, OCC, and Board's general risk-based capital rules, a banking organization must deduct a portion of non-financial equity investments from tier 1 capital. This deduction depends upon the aggregate adjusted carrying value of all non-financial equity investments held directly or indirectly by the banking organization as a percentage of its tier 1 capital. By contrast, OTS rules require the deduction of most equity securities from total capital.<sup>54</sup>

Under this proposed rule, a banking organization would use the simple risk-weight approach (SRWA) for equity exposures that are not exposures to an investment fund. This approach is consistent with the SRWA for equity exposures and investment fund approach provided in the advanced approaches final rule. A banking organization could use the various look-through approaches for equity exposures to an investment fund.

This NPR defines an equity exposure as:

(i) A security or instrument (whether voting or non-voting) that represents a direct or indirect ownership interest in, and is a residual claim on, the assets and income of a company, unless:

(a) The issuing company is consolidated with the banking organization under GAAP;

(b) The banking organization is required to deduct the ownership interest from tier 1 or tier 2 capital under this appendix;

(c) The ownership interest incorporates a payment or other similar obligation on the part of the issuing company (such as an obligation to make periodic payments); or

(d) The ownership interest is a securitization exposure;

(ii) A security or instrument that is mandatorily convertible into a security or instrument described in paragraph (i) of this definition;

(iii) An option or warrant that is exercisable for a security or instrument described in paragraph (i) of this definition; or

(iv) Any other security or instrument (other than a securitization exposure) to the extent the return on the security or instrument is based on the performance of a security or instrument described in paragraph (i) of this definition.

Under the proposed SRWA, a banking organization generally would assign a 300 percent risk weight to publicly

traded equity exposures, a 400 percent risk weight to non-publicly traded equity exposures, and a 600 percent risk weight to certain equity exposures to investment firms as described below. Certain equity exposures to sovereign entities, supranational entities, MDBs, PSEs, and others would have a risk weight of zero percent, 20 percent, or 100 percent; and certain community development equity exposures, the effective portion of hedged pairs, and, up to certain limits, non-significant equity exposures would receive a 100 percent risk weight.

The proposed rule defines publicly traded to mean traded on: (i) Any exchange registered with the SEC as a national securities exchange under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f); or (ii) any non-U.S.-based securities exchange that is registered with, or approved by, a national securities regulatory authority and that provides a liquid, two-way market for the exposure (that is, there are enough independent bona fide offers to buy and sell so that a sales price is reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined promptly and a trade can be settled at such a price within five business days).

A banking organization using the SRWA would determine the adjusted carrying value for each equity exposure. The proposed rule defines the adjusted carrying value of an equity exposure as: (i) For the on-balance sheet component of an equity exposure, the banking organization's carrying value of the exposure reduced by any unrealized gains on the exposure that are reflected in such carrying value but excluded from the banking organization's tier 1 and tier 2 capital;<sup>55</sup> and (ii) for the off-balance sheet component of an equity exposure that is not an equity commitment, the effective notional principal amount of the exposure, the size of which is equivalent to a hypothetical on-balance sheet position in the underlying equity instrument that would evidence the same change in fair value (measured in dollars) for a given small change in the price of the underlying equity instrument, minus the adjusted carrying value of the on-balance sheet component of the exposure as calculated above in (i).

For an unfunded equity commitment that is unconditional, the adjusted carrying value is the effective notional

principal multiplied by a 100 percent conversion factor. If the unfunded equity commitment is conditional, the adjusted carrying value is the effective notional principal amount of the commitment multiplied by a 20 percent conversion factor for a commitment with a maturity of one year or less or multiplied by a 50 percent conversion factor to the effective notional principal amount for a commitment with a maturity of over one year.

The agencies created the concept of the effective notional principal amount of the off-balance sheet portion of an equity exposure to provide a uniform method for banking organizations to measure the on-balance sheet equivalent of an off-balance sheet exposure. For example, if the value of a derivative contract referencing the common stock of company X changes the same amount as the value of 150 shares of common stock of company X, for a small (for example, 1.0 percent) change in the value of the common stock of company X, the effective notional principal amount of the derivative contract is the current value of 150 shares of common stock of company X regardless of the number of shares the derivative contract references. The adjusted carrying value of the off-balance sheet component of the derivative is the current value of 150 shares of common stock of company X minus the adjusted carrying value of any on-balance sheet amount associated with the derivative.

### (2) Hedge Transactions

The agencies are proposing specific rules for recognizing hedged equity exposures. For purposes of determining risk-weighted assets under the SRWA, a banking organization may identify hedge pairs, which would be defined as two equity exposures that form an effective hedge provided each equity exposure is publicly traded or has a return that is primarily based on a publicly traded equity exposure. A banking organization may risk weight only the effective and ineffective portions of a hedge pair rather than the entire adjusted carrying value of each exposure that makes up the pair. Two equity exposures form an effective hedge if the exposures either have the same remaining maturity or each has a remaining maturity of at least three months; the hedge relationship is documented formally before the banking organization acquires at least one of the equity exposures; the documentation specifies the measure of effectiveness (E) (defined below) the banking organization would use for the hedge relationship throughout the life of the transaction; and the hedge relationship

<sup>55</sup> The potential downward adjustment to the carrying value of an equity exposure reflects the fact that 100 percent of the unrealized gains on available-for-sale equity exposures are included in carrying value but only up to 45 percent of any such unrealized gains are included in regulatory capital.

<sup>54</sup> See preamble discussion at section II.E.

has an E greater than or equal to 0.8. A banking organization would measure E at least quarterly and would use one of three alternative measures of E: The dollar-offset method, the variability-reduction method, or the regression method.

It is possible that only part of a banking organization's exposure to a particular equity instrument is part of a hedge pair. For example, assume a banking organization has an equity exposure A with a \$300 adjusted carrying value and chooses to hedge a portion of that exposure with an equity exposure B with an adjusted carrying value of \$100. Also assume that the combination of equity exposure B and \$100 of the adjusted carrying value of equity exposure A form an effective hedge with an E of 0.8. In this situation the banking organization would treat \$100 of equity exposure A and \$100 of equity exposure B as a hedge pair, and the remaining \$200 of its equity exposure A as a separate, stand-alone equity position.

The effective portion of a hedge pair would be E multiplied by the greater of the adjusted carrying values of the equity exposures forming the hedge pair, and the ineffective portion would be (1-E) multiplied by the greater of the adjusted carrying values of the equity exposures forming the hedge pair. In the above example, the effective portion of the hedge pair would be  $0.8 \times \$100 = \$80$  and the ineffective portion of the hedge pair would be  $(1 - 0.8) \times \$100 = \$20$ .

### (3) Measures of Hedge Effectiveness

Under the dollar-offset method of measuring effectiveness, the banking organization would determine the ratio of the cumulative sum of the periodic changes in the value of one equity exposure to the cumulative sum of the periodic changes in the value of the other equity exposure, termed the ratio of value change (RVC). If the changes in the values of the two exposures perfectly offset each other, the RVC would be -1.0. If RVC is positive, implying that the values of the two equity exposures move in the same direction, the hedge is not effective and  $E = 0$ . If RVC is negative and greater than or equal to -1.0 (that is, between zero and -1.0), then E would equal the absolute value of RVC. If RVC is negative and less than -1.0, then E would equal 2.0 plus RVC.

The variability-reduction method of measuring effectiveness compares changes in the value of the combined position of the two equity exposures in the hedge pair (labeled X) to changes in the value of one exposure as though that

one exposure were not hedged (labeled A). This measure of E expresses the time-series variability in X as a proportion of the variability of A. As the variability described by the numerator becomes small relative to the variability described by the denominator, the measure of effectiveness improves, but is bounded from above by a value of one. E would be computed as:

$$E = 1 - \frac{\sum_{t=1}^T (X_t - X_{t-1})^2}{\sum_{t=1}^T (A_t - A_{t-1})^2},$$

Where:

$X_t = A_t - B_t$

$A_t$  = the value at time t of the one exposure in a hedge pair, and

$B_t$  = the value at time t of the other exposure in the hedge pair.

The value of t would range from zero to T, where T is the length of the observation period for the values of A and B, and is comprised of shorter values each labeled t.

The regression method of measuring effectiveness is based on a regression in which the change in value of one exposure in a hedge pair is the dependent variable and the change in value of the other exposure in the hedge pair is the independent variable. E would equal the coefficient of determination of this regression, which is the proportion of the variation in the dependent variable explained by variation in the independent variable. However, if the estimated regression coefficient is positive, then the value of E is zero. The closer the relationship between the values of the two exposures, the higher E will be.

### (4) Simple Risk-Weight Approach (SRWA)

Under the SRWA, a banking organization would determine the risk-weighted asset amount for each equity exposure, other than an equity exposure to an investment fund, by multiplying the adjusted carrying value of the equity exposure, or the effective portion and ineffective portion of a hedge pair as described above, by the lowest applicable risk weight in Table 17. A banking organization would determine the risk-weighted asset amount for an equity exposure to an investment fund under section 52 of the proposed rule.

The banking organization's aggregate risk-weighted asset amount for its equity exposures (other than equity exposures to investment funds) would be equal to the sum of the risk-weighted asset amounts for each of the banking

organization's individual equity exposures.

### (5) Non-Significant Equity Exposures

Under the SRWA, a banking organization may apply a 100 percent risk weight to non-significant equity exposures. The proposed rule defines non-significant equity exposures as equity exposures<sup>56</sup> to the extent that the aggregate adjusted carrying value of the exposures does not exceed 10 percent of the banking organization's tier 1 capital plus tier 2 capital.

When computing the aggregate adjusted carrying value of a banking organization's equity exposures for determining non-significance, the banking organization may exclude (i) equity exposures that receive less than a 300 percent risk weight under the SRWA (other than equity exposures determined to be non-significant); (ii) the equity exposure in a hedge pair with the smaller adjusted carrying value; and (iii) a proportion of each equity exposure to an investment fund equal to the proportion of the assets of the investment fund that are not equity exposures or that qualify as community development equity exposures. If a banking organization does not know the actual holdings of the investment fund, the banking organization may calculate the proportion of the assets of the fund that are not equity exposures based on the terms of the prospectus, partnership agreement, or similar contract that defines the fund's permissible investments. If the sum of the investment limits for all exposure classes within the fund exceeds 100 percent, the banking organization would assume that the investment fund invests to the maximum extent possible in equity exposures.

When determining which of a banking organization's equity exposures qualify for a 100 percent risk weight based on non-significance, a banking organization first would include equity exposures to unconsolidated small business investment companies, or those held through consolidated small business investment companies described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682), then would include publicly traded equity exposures (including those held indirectly through investment funds), and then would include non-publicly traded equity exposures (including those held indirectly through investment funds).

<sup>56</sup> Excluding exposures to an investment firm that would meet the definition of traditional securitization were it not for the primary Federal supervisor's application of paragraph (8) of that definition and has greater than immaterial leverage.

As discussed above in the Securitization section of this NPR, the agencies would have discretion under the proposed rule to exclude from the definition of a traditional securitization those investment firms that exercise substantially unfettered control over the size and composition of their assets, liabilities, and off-balance sheet exposures. Equity exposures to

investment firms that would otherwise be a traditional securitization were it not for the specific agency exclusion are leveraged exposures to the underlying financial assets of the investment firm. The agencies believe that equity exposure to such firms with greater than immaterial leverage warrant a 600 percent risk weight under the SRWA, due to their particularly high risk.

Moreover, the agencies believe that the 100 percent risk weight assigned to non-significant equity exposures is inappropriate for equity exposures to investment firms with greater than immaterial leverage.

The SRWA is summarized in Table 17:

TABLE 17.—SIMPLE RISK-WEIGHT APPROACH

| Risk weight (in percent) | Equity exposure   |
|--------------------------|---|
| 0                        | An equity exposure to a sovereign entity, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, a MDB, a PSE, and any other entity whose credit exposures receive a zero percent risk weight under section 33 of this proposed rule that may be assigned a zero percent risk weight. |
| 20                       | An equity exposure to a Federal Home Loan Bank or Farmer Mac.   |
| 100                      | <ul style="list-style-type: none"> <li>• Community development equity exposures.<sup>57</sup></li> <li>• The effective portion of a hedge pair.</li> <li>• Non-significant equity exposures to the extent less than 10 percent of tier 1 plus tier 2 capital.</li> </ul>  |
| 300                      | A publicly traded equity exposure (other than an equity exposure that receives a 600 percent risk weight and including the ineffective portion of a hedge pair).  |
| 400                      | An equity exposure that is not publicly traded (other than an equity exposure that receives a 600 percent risk weight).   |
| 600                      | An equity exposure to an investment firm that (1) would meet the definition of a traditional securitization were it not for the primary Federal supervisor's application of paragraph (8) of that definition and (2) has greater than immaterial leverage.  |

(6) Equity Exposures to Investment Funds

Under the agencies' general risk-based capital rules, exposures to investments funds are captured through one of two methods. These methods are similar to the alternative modified look-through approach and the simple modified look-through approach described below. The agencies propose two additional options in this NPR, the full look-through approach and money market fund approach.

The agencies are proposing a separate treatment for equity exposures to an investment fund to prevent banks from arbitraging the proposed rule's risk-based capital requirements for certain high-risk exposures and to ensure that banking organizations do not receive a

<sup>57</sup>The proposed rule generally defines these exposures as exposures that would qualify as community development investments under 12 U.S.C. 24 (Eleventh), excluding equity exposures to an unconsolidated small business investment company and equity exposures held through a consolidated small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682). For savings associations, community development investments would be defined to mean equity investments that are designed primarily to promote community welfare, including the welfare of low- and moderate-income communities or families, such as by providing services or jobs, and excluding equity exposures to an unconsolidated small business investment company and equity exposures held through a consolidated small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682).

punitive risk-based capital requirement for equity exposures to investment funds that hold only low-risk assets. Under this proposal, the agencies would define an investment fund as a company (i) all or substantially all of the assets of which are financial assets and (ii) that has no material liabilities. As proposed, a banking organization would determine the risk-weighted asset amount for equity exposures to investment funds using one of four approaches: The full look-through approach, the simple modified look-through approach, the alternative modified look-through approach, or for qualifying investment funds, the money market fund approach, unless the equity exposure to an investment fund is a community development equity exposure. Such community development equity exposures would be subject to a 100 percent risk weight. If an equity exposure to an investment fund is part of a hedge pair, a banking organization could use the ineffective portion of the hedge pair as the adjusted carrying value for the equity exposure to the investment fund. The risk-weighted asset amount of the effective portion of the hedge pair would be equal to its adjusted carrying value. A banking organization could choose to apply a different approach among the four alternatives to different equity exposures to investment funds.

(7) Full Look-Through Approach

A banking organization may use the full look-through approach only if the banking organization is able to compute a risk-weighted asset amount for each of the exposures held by the investment fund. Under the proposed rule, a banking organization would be required to calculate the risk-weighted asset amount for each of the exposures held by the investment fund as if the exposures were held directly by the banking organization. Depending on the exposure type, a banking organization would apply the appropriate proposed rule treatment to an equity exposure to an investment fund. The banking organization's risk-weighted asset amount for the fund would be equal to the total risk-weighted amount for the exposures held by the fund multiplied by the banking organization's proportional interest in the fund.

(8) Simple Modified Look-Through Approach

Under the proposed simple modified look-through approach, a banking organization would set the risk-weighted asset amount for its equity exposure to an investment fund equal to the adjusted carrying value of the equity exposure multiplied by the highest risk weight that applies to any exposure the fund is permitted to hold under its prospectus, partnership agreement, or similar contract that defines the fund's

permissible investments. The banking organization could exclude derivative contracts held by the fund that are used for hedging, not speculative purposes, and do not constitute a material portion of the fund's exposures.

#### (9) Alternative Modified Look-Through Approach

Under this approach, a banking organization may assign the adjusted carrying value of an equity exposure to an investment fund on a pro rata basis to risk-weight categories based on the investment limits in the fund's prospectus, partnership agreement, or similar contract that defines the fund's permissible investments. The risk-weighted amount for the banking organization's equity exposure to the investment fund would be equal to the sum of each portion of the adjusted carrying value assigned to an exposure class multiplied by the applicable risk weight. If the sum of the investment limits for all exposure classes within the fund exceeds 100 percent, the banking organization must assume that the fund invests to the maximum extent permitted under its investment limits in the exposure class with the highest risk weight in this proposed rule, and continues to make investments in the order of the exposure class with the next highest risk weight until the maximum total investment level is reached. If more than one exposure class applies to an exposure, the banking organization would use the highest applicable risk weight. A banking organization could exclude derivative contracts held by the fund that are used for hedging, not speculative, purposes and do not constitute a material portion of the fund's exposures.

#### (10) Money Market Fund Approach

Under this proposed rule, a banking organization may apply a seven percent risk weight to an equity exposure to a money market fund that is subject to SEC rule 2a-7 and that has an applicable external rating in the highest investment-grade category.

### O. Operational Risk

#### (1) Basic Indicator Approach (BIA)

The general risk-based capital rules do not include an explicit capital charge for operational risk. Rather, the general risk-based capital rules were designed to

focus on credit risk. However, due to their broad-brush nature, the rules implicitly cover other types of risks such as operational risk. The more risk-sensitive treatment under the standardized approach for credit risk sharpens the capital measure for that element of the risk-based capital charge and lessens the implicit capital buffer for other risks.

The agencies recognize that operational risk is an important risk and that a number of factors are driving increases in operational risk. These factors include greater use of automated technology; proliferation of new and highly complex products; growth of e-banking transactions and related business applications; large-scale acquisitions, mergers and consolidations; and greater use of outsourcing arrangements. These factors, and in light of the agencies' goal to promote improved risk measurement processes support the inclusion of an explicit capital requirement for operational risk for those institutions that adopt the proposed rule.

Consistent with the New Accord, the agencies propose to implement the BIA for determining a banking organization's risk-based capital requirement for operational risk. The operational risk capital requirement would cover the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events. Operational risk includes legal risk, which is the risk of loss (including litigation costs, settlements, and regulatory fines) resulting from the failure of the banking organization to comply with laws, regulations, prudent ethical standards, and contractual obligations in any aspect of the banking organization's business, but excludes strategic and reputational risks.

Under the BIA, a banking organization's risk-weighted assets for operational risk would equal 15 percent of its average positive annual gross income over the previous three years multiplied by 12.5. The calculation of average positive annual gross income is based on annual gross income as reported by the banking organization in its regulatory financial reports over the three most recent calendar years as discussed below. Gross income is a proxy for the scale of a banking organization's operational risk exposure

and can, in some instances (for example, for a banking organization with low margins or profitability) underestimate the banking organization's capital needs for operational risk. Therefore, a banking organization using the BIA should manage its operational risk consistent with the Basel Committee's "Sound Practices for the Management and Supervision of Operational Risk" guidance, which includes a set of principles for the effective management of operational risk.<sup>58</sup>

The proposed rule defines average positive annual gross income as the sum of the banking organization's positive annual gross income, as described below, over the three most recent calendar years. This calculation would not include any amounts from any year in which annual gross income is negative or zero; that is, it is the sum of its positive annual gross income divided by the number of years in which its annual gross income was positive. Annual gross income would equal:

(i) For a bank, its net interest income plus its total noninterest income minus its underwriting income from insurance and reinsurance activities as reported on the bank's year-end Consolidated Reports of Condition and Income (Call Report).

(ii) For a bank holding company, its net interest income plus its total noninterest income minus its underwriting income from insurance and reinsurance activities as reported on the bank holding company's Consolidated Financial Statements for Bank Holding Companies (Y9-C Report).

(iii) For a savings association, its net interest income (expense) before provision for losses on interest-bearing assets, plus total noninterest income, minus the portion of its other fees and charges that represents income derived from insurance and reinsurance underwriting activities, minus (plus) its income (loss) from the sale of assets held-for-sale and available-for-sale securities to include only the profit or loss from the disposition of available-for-sale securities pursuant to FASB Statement No. 115, minus (plus) its income (loss) from the sale of securities held-to-maturity, all as reported on the savings association's year-end Thrift Financial Report (TFR).

<sup>58</sup> See the February 2003 BCBS publication entitled "Sound Practices for the Management and Supervision of Operational Risk."

Table 18 illustrates the relevant components of average positive annual gross income from regulatory reports.

TABLE 18.—CALCULATION OF GROSS INCOME FOR BIA

| For Bank FFIEC 031/041, BHC Y–9C, and TFR reporting |                                   |  | Call report | Y–9C  | TFR                |
|---|-----------------------------------|--|-------------|-------|--------------------|
| Item No.  | Item No. from Schedules RI and HI | Description  | RIAD        | BHC K | SO                 |
| 1   | 3                                 | Net interest income  | 4074        | 4074  | SO312              |
| 2   | 5.m                               | Total noninterest income   | 4079        | 4079  | SO42               |
| 3   | 5.d.(4)                           | Underwriting income from insurance and reinsurance activities.     | C386        | C386  | n/a                |
| 4   | n/a                               | Other fees and charges   | n/a         | n/a   | <sup>1</sup> SO420 |
| 5   | n/a                               | Sale of assets held-for-sale and of available-for-sale securities. | n/a         | n/a   | <sup>2</sup> SO430 |
| 6   | n/a                               | Sale of securities held-to-maturity                                | n/a         | n/a   | SO467              |
| 7   | n/a                               | Gross income for BIA   |             |       |                    |

<sup>1</sup> Include only the portion of SO420 that represents income derived from insurance and reinsurance underwriting activities.

<sup>2</sup> Include only “profit or loss from the disposition of available-for-sale securities pursuant to FASB Statement No. 115” from SO430.

*Question 19: The agencies solicit comment on this proposed treatment of operational risk, and, in particular, on the appropriateness of the proposed average positive gross income calculation.*

(2) Advanced Measurement Approaches (AMA)

Under the AMA framework of the New Accord, a banking organization that meets the qualifying criteria for AMA would use its internal operational risk quantifications system to calculate its risk-based capital requirement for operational risk. The AMA framework is fully discussed in the advanced approaches final rule. The specific references in the advanced approaches final rule’s preamble and common rule text are: (i) Preamble;<sup>59</sup> (ii) section 22(c) and certain other paragraphs in section 22 of the common rule text,<sup>60</sup> such as (a)(2) and (3), (i), (j), and (k), which discuss advanced systems in general and therefore would apply to AMA; (iii) sections 22(h), 61, and 62 of the common rule text;<sup>61</sup> (iv) applicable definitions in section 2 of the common rule text;<sup>62</sup> and (v) applicable disclosure requirements in Table 11.9 of the common rule text.<sup>63</sup>

Under the New Accord, the AMA option may be made available for banking organizations that apply any of the New Accord’s approaches to credit risk. The agencies are considering whether to implement the AMA option in a standardized framework final rule consistent with the requirements in the

advanced approaches final rule. Accordingly, the agencies would like to know whether any banking organizations that would be eligible to opt in to a standardized framework believe that they can meet the advance systems requirements that would qualify them to use the more complex AMA approach for calculating their risk-based capital requirement for operational risk.

*Question 20: The agencies therefore solicit comment on the appropriateness of including the AMA for calculating the risk-based capital requirement for operational risk in any final rule implementing the standardized framework and the extent to which banking organizations implementing the standardized approach believe they can meet the associated advanced modeling and systems requirements.*

P. Supervisory Oversight and Internal Capital Adequacy Assessment

One of the objectives of the New Accord is to provide incentives for banking organizations to develop and apply better techniques for measuring and managing risks and ensuring that capital is adequate to support those risks, not just to meet minimum regulatory capital requirements. Consistent with the agencies’ general risk-based capital rules and Pillar 2 of the New Accord, the proposed rule would require a banking organization to hold capital that is commensurate with the level and nature of all risks to which the banking organization is exposed, and to have both a rigorous process for assessing its overall capital adequacy in relation to its risk profile and a comprehensive strategy for maintaining appropriate capital levels.

Consistent with existing supervisory practice, a banking organization’s primary Federal supervisor would evaluate a banking organization’s compliance with the minimum capital requirements and also evaluate how well the banking organization is assessing its capital needs relative to its risks and capital goals. Also, consistent with existing supervisory practice, a primary Federal supervisor may require a banking organization under its jurisdiction to increase its capital levels or reduce its risk exposures if capital is deemed inadequate relative to a banking organization’s risk profile.

Q. Market Discipline

(1) Overview

The general risk-based capital rules do not require disclosures beyond the filing of the risk-based capital section of the agencies’ regulatory reports (that is, FR Y9–C, Call Reports, TFR, etc). The agencies, however, have long supported meaningful public disclosure by banking organizations to improve market discipline. The agencies recognize the importance of market discipline in encouraging sound risk management practices and fostering financial stability.

Pillar 3 of the New Accord, market discipline, complements the minimum capital requirements and the supervisory review process by encouraging market discipline through enhanced and meaningful public disclosure. These proposed public disclosure requirements are intended to allow market participants to assess key information about a banking organization’s risk profile and its associated level of capital.

<sup>59</sup> See 72 FR 69302–21, 69382–84, and 69293–94 (December 7, 2007).

<sup>60</sup> Id. at 69407–08.

<sup>61</sup> Id. at 69407–08 and 69428–29.

<sup>62</sup> Id. at 69397–405.

<sup>63</sup> Id. at 69436.

With enhanced transparency, investors can better evaluate a banking organization's capital structure, risk exposures, and capital adequacy. With sufficient and relevant information, market participants can better evaluate a banking organization's risk management performance, earnings potential, and financial strength.

Improvements in public disclosures come not only from regulatory standards, but also through efforts by a banking organization's management to improve communications to public shareholders and other market participants. In this regard, improvements to risk management processes and internal reporting systems provide opportunities to improve significantly public disclosures over time. Accordingly, the agencies strongly encourage the management of each banking organization to review regularly its public disclosures and enhance these disclosures, where appropriate, to identify clearly all significant risk exposures, whether on- or off-balance sheet, and their effects on the banking organization's financial condition and performance, cash flow, and earnings potential.

## (2) General Requirements

The proposed public disclosure requirements apply to the top-tier legal entity that is a banking organization within a consolidated banking group (that is, the top-tier banking organization). In general, a banking organization that is a subsidiary of a bank holding company (BHC) or another banking organization would not be subject to the disclosure requirements, except that every banking organization would have to disclose total and tier 1 capital ratios and their components, similar to current requirements. If a banking organization is not a subsidiary of a BHC or another banking organization that must make the full set of disclosures, the banking organization would have to make these disclosures.

A banking organization's exposure to risk and the techniques that it uses to identify, measure, monitor, and control those risks are important factors that market participants consider in their assessment of the institution. Accordingly, each banking organization that is subject to the disclosure requirements would have a formal disclosure policy approved by its board of directors that addresses the banking organization's approach for determining the disclosures it should make. The policy should address the associated internal controls and disclosure controls and procedures. The board of directors and senior management would have to

ensure that appropriate review of the disclosures takes place and that effective internal controls and disclosure controls and procedures are maintained.

A banking organization should decide which disclosures are relevant for it based on a materiality concept. Information would be regarded as material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information for the purpose of making investment decisions.

A banking organization may be able to fulfill some of the proposed disclosure requirements by relying on similar disclosures made in accordance with accounting standards or SEC mandates. In these situations, a banking organization must explain material differences between the accounting or other disclosures and the disclosures required under this proposed rule.

## (3) Frequency/Timeliness

Consistent with longstanding requirements in the United States for robust quarterly disclosures in financial and regulatory reports, and considering the potential for rapid changes in risk profiles, this NPR would require that quantitative disclosures be made quarterly. However, qualitative disclosures that provide a general summary of a banking organization's risk management objectives and policies, reporting system, and definitions may be disclosed annually, provided any significant changes to these are disclosed in the interim. The disclosures must be timely, that is, made by the reporting deadline for financial reports (for example SEC forms 10-Q and 10-K) or 45 days after the calendar quarter-end. When these deadlines differ, the later deadline should be used.

In some cases, management may determine that a significant change has occurred, such that the most recent reported amounts do not reflect the banking organization's capital adequacy and risk profile. In those cases, a banking organization would have to disclose the general nature of these changes and briefly describe how they are likely to affect public disclosures going forward. A banking organization would make these interim disclosures as soon as practicable after the determination that a significant change has occurred.

## (4) Location of Disclosures and Audit/Certification Requirements

The disclosures would have to be publicly available (for example, included on a public Web site) for each

of the last three years or such shorter time period since the banking organization opted into the standardized framework. Except as discussed below, management would have some discretion to determine the appropriate medium and location of the disclosure. Furthermore, a banking organization would have flexibility in formatting its public disclosures.

The agencies encourage management to provide all of the required disclosures in one place on the entity's public Web site. The public Web site address would be reported in a regulatory report. Alternatively, banking organizations would be permitted to provide the disclosures in more than one place, as some of them may be included in public financial reports (for example, in Management's Discussion and Analysis included in SEC filings) or other regulatory reports. The agencies would encourage such banking organizations to provide a summary table on their public Web site that specifically indicates where all the disclosures may be found (for example, regulatory report schedules, pages numbers in annual reports).

Disclosures of tier 1 and total capital ratios would be tested by external auditors as part of the financial statement audit, if the banking organization is required to obtain financial statement audits. Disclosures that are not included in the footnotes to the audited financial statements are not subject to external audit reports for financial statements or internal control reports from management and the external auditor. Due to the importance of reliable disclosures, the agencies would require one or more senior officers to attest that the disclosures would meet the proposed disclosure requirements. The senior officer may be the chief financial officer, the chief risk officer, an equivalent senior officer, or a combination thereof.

## (5) Proprietary and Confidential Information

The agencies believe that the proposed requirements strike an appropriate balance between the need for meaningful disclosure and the protection of proprietary and confidential information.<sup>64</sup> Accordingly, the agencies believe that banking organizations would be able to provide

<sup>64</sup> Proprietary information encompasses information that, if shared with competitors, would render a banking organization's investment in these products/systems less valuable, and, hence, could undermine its competitive position. Information about customers is often confidential, in that it is provided under the terms of a legal agreement or counterparty relationship.

all of these disclosures without revealing proprietary and confidential information. Only in rare circumstances might disclosure of certain items of information required by the proposed rule compel a banking organization to reveal confidential and proprietary information. In these unusual situations, the agencies propose that if a banking organization believes that disclosure of specific commercial or financial information would prejudice seriously the position of the banking organization by making public information that is either proprietary or confidential in nature, the banking organization need not disclose those specific items. Instead, the banking organization must disclose more general information about the subject matter of the requirement, together with the fact that, and the reason why, the specific items of information have not been disclosed. This provision would apply only to those disclosures included in this NPR and does not apply to disclosure requirements imposed by accounting standards or other regulatory agencies.

*Question 21: The agencies seek commenters' views on all of the elements of the proposed public disclosure requirements. In particular, the agencies seek comment on the extent to which the proposed disclosures balance providing market participants with sufficient information to appropriately assess the risk profile and capital strength of individual institutions, fostering comparability across banking organizations, and minimizing burden on the banking organizations that are reporting the information. The agencies further request comment on whether certain banking organizations (for example, those not publicly listed or not required to have audited financial statements) should be exempt or have more limited disclosure requirements and, if so, how to preserve competitive equity with banking organizations required to make a full set of disclosures.*

#### (6) Summary of Specific Public Disclosure Requirements

The public disclosure requirements described in the tables in the proposed rule provide important information to market participants on the scope of application, capital, risk exposures, risk assessment processes, and, hence, the capital adequacy of the banking organization. The table numbers below refer to the table numbers in the proposed rule. For each separate risk area described in Table 15.4 through 15.10, the banking organization would be required to describe its risk management objectives and policies.

The agencies expect that these objectives and policies would include: (i) Strategies and processes; (ii) the structure and organization of the relevant risk management function; (iii) the scope and nature of risk reporting and/or measurement systems; and (iv) policies for hedging and/or mitigating risk and strategies and processes for monitoring the continuing effectiveness of hedges/mitigants.

A banking organization should focus on the substantive content of the tables, not the tables themselves. The proposed disclosures are:

- Table 15.1, Scope of Application, would include a description of the level in the banking organization to which the disclosures apply and an outline of any differences in consolidation for accounting and regulatory capital purposes, as well as a description of any restrictions on the transfer of funds and capital within the banking organization. These disclosures provide the basic context underlying regulatory capital calculations.
- Table 15.2, Capital Structure, would provide information on various components of regulatory capital available to absorb losses and allow for an evaluation of the quality of the capital available to absorb losses within the banking organization.
- Table 15.3, Capital Adequacy, would provide information about how a banking organization assesses the adequacy of its capital and set requirements that the banking organization disclose its risk-weighted asset amounts for various asset categories. The table also requires disclosure of the regulatory capital ratios of the consolidated group and each DI subsidiary. Such disclosures provide insight into the overall adequacy of capital based on the risk profile of the banking organization.
- Tables 15.4 and 15.6, Credit Risk, would provide information for different types and concentrations of a banking organization's exposure to credit risk and the techniques the banking organization uses to measure, monitor, and mitigate that risk.
- Table 15.5, General Disclosures for Counterparty Credit Risk-Related Exposures, would provide information related to counterparty credit risk-related exposures.
- Table 15.7, Securitization, would provide information to market participants on the amount of credit risk transferred and retained by the banking organization through securitization transactions and the types of products securitized by the organization. These disclosures provide users a better understanding of how securitization

transactions impact the credit risk of the banking organization.

- Table 15.8, Operational Risk, would provide insight into the banking organization's operational risk exposure.
- Table 15.9, Equities Not Subject to the Market Risk Rule, would provide market participants with an understanding of the types of equity securities held by the banking organization and how they are valued. This disclosure also would provide information on the capital allocated to different equity products and the amount of unrealized gains and losses.
- Table 15.10, Interest Rate Risk in Non-Trading Activities, would provide information about the potential risk of loss that may result from changes in interest rates and how the banking organization measures such risk.

### III. Regulatory Analysis

#### A. 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 advanced approaches final rule. 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 NPR noted that small banking organizations typically hold



more capital than is required by the capital rules and would prefer to remain under the general risk-based capital rules. For these reasons, the proposal will not result in a significant economic impact on a substantial number of small entities.

#### *B. 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 \$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."<sup>65</sup> Regulatory actions that satisfy one or more of these criteria are referred to as "economically significant regulatory actions."

Based on the OCC's estimate of the number of national banks likely to adopt this proposal and the proposal's total cost of approximately \$74 million, the proposed rule would not have an annual effect on the economy of \$100 million or more. In light of certain unique features of the proposal, the OCC has nevertheless prepared this regulatory impact analysis. Specifically, this proposal affords most national banks the option to apply this approach, which results in additional uncertainty in estimating the total costs.

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 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) 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; Capital Adequacy Guidelines; Capital Maintenance: Standardized Risk-Based Capital Rules (Basel II: Standardized Option), Office of the Comptroller of the Currency, International and Economic Affairs (2008)".

#### **I. The Need for the Regulatory Action**

Federal banking law directs federal banking agencies, including the Office of the Comptroller of the Currency (OCC), to require banking organizations to hold adequate capital. The law authorizes federal banking agencies to set minimum capital levels to ensure that banking organizations maintain adequate capital. The law also gives

federal banking agencies broad discretion with respect to capital regulation by authorizing them to also use any other methods that they deem appropriate to ensure capital adequacy.

Capital regulation seeks to address market failures that stem from several sources. Asymmetric information about the risk in a banking organization's portfolio creates a market failure by hindering the ability of creditors and outside monitors to discern a banking organization's actual risk and capital adequacy. Moral hazard creates market failure in which the banking organization's creditors fail to restrain the banking organization from taking excessive risks because deposit insurance either fully or partially protects them from losses. Public policy addresses these market failures because individual banks fail to adequately consider the positive externality or public benefit that adequate capital brings to financial markets and the economy as a whole.

Capital regulations cannot be static. Innovation in and transformation of financial markets require periodic reassessments of what may count as capital and what amount of capital is adequate. Continuing changes in financial markets create both a need and an opportunity to refine capital standards in banking. The proposed revisions to U.S. risk-based capital rules, "Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Standardized Risk-Based Capital Rules" (standardized option), which we address in this impact analysis, provide a new option for determining risk-based capital for banking organizations not required to operate under "Risk-Based Capital Standards: Advanced Capital Adequacy Framework" (advanced approaches). The standardized option and the advanced approaches reflect the implementation in the United States of the Basel Committee on Banking Supervision's "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (New Accord).

#### **II. Regulatory Background**

The proposed capital regulation examined in this analysis would apply to commercial banks and savings associations (collectively, banks). Three banking agencies, the OCC, the Board of Governors of the Federal Reserve System (Board), and the Federal Deposit Insurance Corporation (FDIC) regulate commercial banks, while the Office of Thrift Supervision (OTS) regulates all federally chartered and many state-chartered savings associations.

<sup>65</sup>Executive Order 12866 (September 30, 1993), 58 FR 51735 (October 4, 1993), as amended by Executive Order 13258, 67 FR 9385 (February 28, 2002) and by Executive Order 13422, 72 FR 2763 (January 23, 2007). For the complete text of the definition of "significant regulatory action," see E.O. 12866 at § 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 § 3(e).

Throughout this document, the four are jointly referred to as the federal banking agencies.

The New Accord comprises three mutually reinforcing “pillars” as summarized below.

#### 1. Minimum Capital Requirements (Pillar 1)

The first pillar establishes a method for calculating minimum regulatory capital. It sets new requirements for assessing credit risk and operational risk while generally retaining the approach to market risk as developed in the 1996 amendments to the 1988 Accord.

The New Accord offers banks a choice of three methodologies for calculating the capital charge for credit risk. The first approach, called the standardized approach, essentially refines the risk-weighting framework of the 1988 Accord. The other two approaches are variations on an internal ratings-based (IRB) approach that leverages banks’ internal credit-rating systems: A “foundation” methodology, whereby banks estimate the probability of borrower or obligor default, and an “advanced” approach, whereby organizations also supply other inputs needed for the capital calculation. In addition, the new framework uses more risk-sensitive methods for dealing with collateral, guarantees, credit derivatives, securitizations, and receivables.

The New Accord also introduces an explicit capital requirement for operational risk.<sup>66</sup> The New Accord offers banking organizations a choice of three methodologies for calculating their capital charge for operational risk. The first method, called the basic indicator approach, requires banks to hold capital for operational risk equal to 15 percent of annual gross income (averaged over the most recent three years). The second option, called the standardized approach, uses a formula that divides a banking organization’s activities into eight business lines, calculates the capital charge for each business line as a fixed percentage of gross income (12 percent, 15 percent, or 18 percent depending on the nature of the business, again averaged over the most recent three years), and then sums across business lines. The third option, called the advanced measurement approaches (AMA), uses an institution’s internal operational risk measurement system to determine the capital requirement.

<sup>66</sup> Operational risk is the risk of loss resulting from inadequate or failed processes, people, and systems or from external events. It includes legal risk but excludes strategic risk and reputation risk.

#### 2. Supervisory Review Process (Pillar 2)

The second pillar calls upon banking organizations to have an internal capital assessment process and banking supervisors to evaluate each banking organization’s overall risk profile as well as its risk management and internal control processes. This pillar establishes an expectation that banking organizations hold capital beyond the minimums computed under Pillar 1, including additional capital for any risks that are not adequately captured under Pillar 1. It encourages banking organizations to develop better risk management techniques for monitoring and managing their risks. Pillar 2 also charges supervisors with the responsibility to ensure that banking organizations using advanced Pillar 1 techniques, such as the advanced IRB approach to credit risk and the AMA for operational risk, comply with the minimum standards and disclosure requirements of those methods, and take action promptly if capital is not adequate.

#### 3. Market Discipline (Pillar 3)

The third pillar of the New Accord sets minimum disclosure requirements for banking organizations. The disclosures, covering the composition and structure of the banking organization’s capital, the nature of its risk exposures, its risk management and internal control processes, and its capital adequacy, are intended to improve transparency and strengthen market discipline. By establishing a common set of disclosure requirements, Pillar 3 seeks to provide a consistent and understandable disclosure framework that market participants can use to assess key pieces of information on the risks and capital adequacy of a banking organization.

#### 4. U.S. Implementation

The proposed standardized option rule seeks to improve the risk sensitivity of existing risk-based capital rules. The standardized option would be voluntary and available to banking organizations not subject to the advanced approaches rule. Any institution that is not an advanced approaches bank would be able to remain under the existing risk-based capital rules or elect to adopt the standardized option. The standardized option would:

1. Include a capital requirement for operational risk.
2. Use external credit ratings to risk weight sovereign, public sector entity, corporate, and securitization exposures.
3. Use the risk weight of the appropriate sovereign to assign risk weights for exposures to banks.

4. Use loan-to-value ratios to risk-weight residential mortgages.

5. Lower the risk weights for some retail exposures and small loans to businesses.

6. Expand the range of credit risk mitigation techniques that are recognized for risk-based capital purposes, including expanding the range of recognized collateral and eligible guarantors.

7. Increase the credit conversion factor for certain commitments with an original maturity of one year or less that are not unconditionally cancelable.

8. Revise the risk weights for securitization exposures and assess a capital charge for early amortizations in securitizations of revolving exposures.

9. Remove the 50 percent limit on the risk weight for certain derivative transactions.

10. Revise the risk-based capital treatment for unsettled and failed trades for securities, foreign exchange, and commodities.

11. Expand the range of methodologies available to banking organizations for measuring counterparty credit risk.

The Agencies would continue to reserve the authority to require banking organizations to hold additional capital where appropriate.

### III. Cost-Benefit Analysis of the Proposed Rule

A cost-benefit analysis considers the costs and benefits of a proposal as they relate to society as a whole. The social benefits of a proposal are benefits that accrue directly to those subject to a proposal plus benefits that might accrue indirectly to the rest of society. Similarly, the overall social costs of a proposal are costs incurred directly by those subject to the rule and costs incurred indirectly by others. In the case of the Standardized Option, direct costs and benefits are those that apply to the banking organizations that are subject to the proposal. Indirect costs and benefits then stem from banks and other financial institutions that are not subject to the proposal, bank customers, and, through the safety and soundness externality, society as a whole.

The broad social and economic benefit that derives from a safe and sound banking system supported by vigorous and comprehensive supervision, including ensuring adequate capital, clearly dwarfs any direct benefits that might accrue to institutions adopting the Standardized Option. Similarly, the social and economic cost of any reduction in the safety and soundness of the banking system would dramatically overshadow

any cost borne by banking organizations subject to the rule. The banking agencies are confident that the enhanced risk sensitivity of the proposed rule could allow banking organizations to more effectively achieve objectives that are consistent with a safe and sound banking system.

Beyond this societal benefit from maintaining a safe and sound banking system, we do not anticipate additional benefits outside of those accruing directly to the banking organizations that elect to adopt the Standardized Option. Because many factors besides regulatory capital requirements affect pricing and lending decisions, we do not expect the adoption or non-adoption of the Standardized Option to affect pricing or lending. Hence, we do not anticipate any costs or benefits affecting the customers or competitors of institutions adopting the Standardized Option. For these reasons, the cost and benefit analysis of the Standardized Option is primarily an analysis of the costs and benefits directly attributable to institutions that might elect to adopt its capital rules.

#### A. Organizations Affected by the Proposed Rule<sup>67</sup>

As of December 31, 2007, twelve banking organizations meet the criteria that would require them to adopt the U.S. implementation of the New Accord's advanced approaches. Removing those twelve mandatory advanced approaches institutions from the 7,415 FDIC-insured banking organizations active in December 2007 leaves 7,403 organizations that would be eligible to adopt the Standardized Option. Seven of the twelve mandatory advanced approaches institutions are national banks. Out of 1,421 banking organizations with national banks, 1,414 national banking organizations would thus be eligible to adopt the Standardized Option.

#### B. Benefits of the Proposed Rule

The proposed rule aims to enhance safety and soundness by improving the risk sensitivity of regulatory capital requirements. The proposed rule:

1. Enhances the risk sensitivity of capital charges.
2. Facilitates more efficient use of required bank capital.
3. Recognizes new developments in financial markets.
4. Mitigates potential distortions in minimum regulatory capital requirements between Advanced

Approaches banking organizations and other banking organizations.

5. Better aligns capital and operational risk and encourages banking organizations to mitigate operational risk.

6. Enhances supervisory feedback.

7. Promotes market discipline through enhanced disclosure.

8. Preserves the benefits of international consistency and coordination achieved with the 1988 Basel Accord.

9. Offers long-term flexibility to banking organizations by providing the ability to opt in to the standardized approach.

#### C. Costs of the Proposed Rule

As with any rule, the costs of the proposal include necessary expenditures by banks and thrifts necessary to comply with the new regulation and costs to the federal banking agencies of implementing the new rules. Because of a lack of cost estimates from banking organizations, the OCC found it necessary to use a scope-of-work comparison with the Advanced Approaches in order to arrive at a cost estimate for the Standardized Option. Based on this rough assessment, we estimate that implementation costs for the Standardized Option could range from \$200,000 at smaller institutions to \$5 million at larger institutions.

##### 1. Costs to Banking Organizations

Explicit costs of implementing the proposed rule at banking organizations fall into two categories: Setup costs and ongoing costs. Setup costs are typically one-time expenses associated with introducing the new programs and procedures necessary to achieve initial compliance with the proposed rule. Setup costs may also involve expenses related to tracking and retrieving data needed to implement the proposed rule. Ongoing costs are also likely to reflect data costs associated with retrieving and preserving data.

The total cost of the standardized option depends entirely on the number and size of institutions that elect to adopt the voluntary rule. Obviously, if the number of institutions adopting the standardized option is zero, then the cost to banks will be zero. Based on comment letters and discussions with bank supervision staff, we sought to identify national banks that would be most likely to adopt the standardized option. Because one of the principal changes in the standardized option affects the risk weighting for residential mortgages, we selected national banks with significant mortgage holdings as the more likely adopters of the new rule.

In particular, our list of more likely adopters includes national banks where one-to-four family first-lien mortgages comprise over 30 percent of all assets if the institution has less than \$1 billion in assets and where the mortgage to asset ratio is over 20 percent at larger institutions. We also include the few national banks that do not meet the well-capitalized threshold for their risk based capital-to-assets ratio as of December 31, 2007. Using those criteria, we identified 113 national banks, which if they adopted the standardized option would result in a total cost to national banks of approximately \$74 million. Over time, the standardized option may become more appealing to a larger number of banks. The total cost of the proposed rule would consequently increase to the extent that more institutions opt into the standardized option over time. At present, it is unclear how many national banks will ultimately elect to adopt the standardized option. The standardized option's provision for an explicit charge for operational risk is another important factor that national banks will undoubtedly consider in assessing whether to adopt the standardized option. Although we are unable to estimate how many of our estimated adopters might be dissuaded from the standardized option because of an operational risk capital charge, we do believe that the explicit charge for operational risk could significantly reduce the number of likely adopters.<sup>68</sup>

##### 2. Government Administrative Costs

Like the banking organizations subject to new requirements, the costs to government agencies of implementing the proposed rule also involve both startup and ongoing costs. Startup costs include expenses related to the development of the regulatory proposals, costs of establishing new programs and procedures, and costs of initial training of bank examiners in the new programs and procedures. Ongoing costs include maintenance expenses for any additional examiners and analysts needed to regularly apply the new supervisory processes. In the case of the standardized option, because modest changes to Call Reports will capture most of the rule changes, these ongoing costs are likely to be minor.

OCC expenditures fall into three broad categories: Training, guidance,

<sup>67</sup> Unless otherwise noted, the population of banks and thrifts used in this analysis consists of all FDIC-insured institutions. Banking organizations are aggregated to the top holding company level.

<sup>68</sup> If the advanced measurement approach (AMA) option for operational risk were to be made available as part of the standardized option, we believe that its considerable startup requirements and accompanying costs would dissuade almost all institutions with less than \$10 billion in assets from pursuing the AMA operational risk option.

and supervision. Training includes expenses for workshops and other training courses and seminars for examiners. Guidance expenses reflect expenditures on the development of standardized option guidance. Supervision expenses reflect organization-specific supervisory activities. We estimate that OCC expenses for the standardized option will be approximately \$4.3 million through 2008. We also expect expenditures of \$1 million per year between 2009 and 2011. Applying a five percent discount rate to future expenditures, past expenses (\$4.3 million) plus the present value of future expenditures (\$2.7 million) equals total OCC expenditures of \$7 million on the standardized option.

### 3. Total Cost Estimate of Proposed Rule

The OCC's estimate of the total cost of the proposed rule includes expenditures by banking organizations and the OCC from the present through 2011. Based on our estimate that approximately 113 national banks will adopt the standardized option at a cost to each institution of between \$200,000 and \$5 million depending on the size of the institution, we estimate that national banks will spend approximately \$74 million on the standardized option. Combining expenditures provides an estimate of \$81 million for the total cost of the proposed rule for the OCC and national banks.

## IV. Analysis of Baseline and Alternatives

In order to place the costs and benefits of the proposed rule in context, Executive Order 12866 requires a comparison between the proposed rule, a baseline of what the world would look like without the proposed rule, and a reasonable alternative to the proposed rule. In this regulatory impact analysis, we analyze one baseline and one alternative to the proposed rule. The baseline considers the possibility that the proposed standardized option rule is not adopted and current capital standards continue to apply.

The baseline scenario appears in this analysis in order to estimate the effects of adopting the proposed rule relative to a hypothetical regulatory regime that might exist without the Standardized Option. Because the baseline scenario considers costs and benefits as if the proposed rule never existed, we set the costs and benefits of the baseline scenario to zero. Obviously, banking organizations face compliance costs and reap the benefits of a well-capitalized banking system even under the baseline. However, because we cannot quantify

these costs and benefits, we normalize the baseline costs and benefits to zero and estimate the costs and benefits of the proposed rule and alternative as deviations from this zero baseline.

1. Baseline Scenario: Current capital standards based on the 1988 Basel Accord continue to apply.

### *Description of Baseline Scenario*

Under the Baseline Scenario, current capital rules would continue to apply to all banking organizations in the United States that are not subject to the U.S. implementation of the advanced approaches. Under this scenario, the United States would not adopt the proposed standardized option, but the implementation of the advanced approaches final rule would continue.

### *Change in Benefits: Baseline Scenario*

Staying with current capital rules instead of adopting the standardized option proposal would eliminate the nine benefits of the proposed rule listed above. Under the baseline, banking organizations not subject to the advanced approaches would not be given the option of voluntarily selecting the standardized option. Institutions that would have adopted the standardized option would not be able to take advantage of the enhanced risk sensitivity of its capital charges and the more efficient use of bank capital that implies.

Without the standardized option, an institution would have to choose between the advanced approaches and the status quo. The baseline without the standardized option would leave a level playing field for all the non-core banks. However, the absence of an opportunity to mitigate potential distortions in minimum required capital would likely diminish this benefit in the eyes of an institution concerned about potential distortions created by the implementation of the advanced approaches.

### *Changes in Costs: Baseline Scenario*

Continuing to use current capital rules eliminates the benefits and the costs of adopting the proposed rule. As discussed above, under the proposed rule we estimate that organizations would spend up to \$74 million on implementation-related expenditures. Retaining current capital rules would eliminate any costs associated with the proposed rule, even though banking organizations would only incur those costs if they elected to do so.

2. Alternative: Require all U.S. banking organizations not subject to the Advanced Approaches rule to adopt the Standardized Option.

### *Description of Alternative*

The only change between the proposed rule and the alternative is that adoption of the proposed rule would be mandatory under the alternative rather than voluntary. Under this alternative, the provisions of the proposed rule would remain intact and apply to all national banks that are not subject to the advanced approaches rule, i.e., mandatory advanced approaches institutions and those institutions that elect to adopt the advanced approaches framework.

### *Change in Benefits: Alternative*

Because there are no changes to the elements of the proposed rule under the alternative, the list of benefits remains the same. Among these benefits, only one benefit is lost by making the proposed rule mandatory: The benefit derived from the fact that the proposed rule is voluntary. As for the benefits relating to the enhanced risk sensitivity of capital charges, because adoption of the standardized option is mandatory under the alternative, more banks will be subject to the standardized option provisions and the aggregate level of benefits will be higher. Because we estimate that 113 national banks would adopt the standardized option voluntarily, the difference in the aggregate benefit level could be considerable.

### *Changes in Costs: Alternative*

Clearly the most significant drawback to the alternative is the dramatically increased cost of applying a new set of capital rules to almost all U.S. banking organizations. Under the alternative, direct costs would increase for every U.S. banking organization that would have elected to continue to use current capital rules under the proposed rule. The cost estimate for the alternative is the total cost estimate for a 100 percent adoption rate of the standardized option. With 1,414 national banking organizations eligible for the standardized option, we estimate that the cost to national banking organizations of the alternative is approximately \$740 million. The actual cost may be somewhat less depending on the number of national banks that elect to adopt the advanced approaches rule, but it is much greater than our cost estimate of \$74 million for the proposed rule.

### 3. Overall Comparison of Proposed Rule with Baseline and Alternative.

The New Accord and its U.S. implementation seek to incorporate risk measurement and risk management advances into capital requirements.

Risk-sensitive capital requirements are integral to ensuring an adequate capital cushion to absorb financial losses at financial institutions. In implementing the standardized option in the United States, the agencies' intent is to enhance risk sensitivity while maintaining a regulatory capital regime that is as rigorous as the current system. Total capital requirements under the standardized option, including capital for operational risk, will better allocate capital in the system. A better allocation will occur regardless of whether the minimum required capital at a particular institution is greater or less than it would be under current capital rules.

The objective of the proposed rule is to enhance the risk sensitivity of capital charges for institutions not subject to the advanced approaches rule. The proposal also seeks to mitigate any potential distortions in minimum regulatory capital requirements that the implementation of the advanced approaches rule might create between large and small banking organizations. Like the Advanced Approaches rule, the anticipated benefits of the standardized option proposal are difficult to quantify in dollar terms. Nevertheless, the OCC believes that the proposed rule provides benefits associated with enhanced risk sensitivity and preserves the safety and soundness of the banking industry and the security of the Federal Deposit Insurance system. To offset the costs of the proposed rule, its voluntary nature offers regulatory flexibility that will allow institutions to adopt the standardized option on a bank-by-bank basis when an institution's anticipated benefits exceed the anticipated costs of adopting this regulation.

The banking agencies are confident that the proposed rule could serve to strengthen institutions electing to adopt the standardized option while the safety and soundness of institutions electing to forgo the standardized option and the advanced approaches rule will not diminish. On the basis of our analysis, we believe that the benefits of the proposed rule are sufficient to offset the costs of implementing the proposed rule. However, with safety and soundness secure under either capital rule, we believe it is best to make the proposed rule voluntary in order to let each national bank decide whether it is in that institution's best interest to adopt the standardized option. This will help to ensure that the costs associated with implementation of the standardized option do not rise precipitously and outweigh the benefits. Because adoption is voluntary, the proposed rule offers an improvement

over the baseline scenario and the alternative. The proposed rule offers an important degree of flexibility unavailable with either the baseline or the alternative. The baseline does not give banking organizations a way into the standardized option and the alternative does not offer them a way out. The alternative for mandatory adoption would compel most banking organizations to follow a new set of capital rules and require them to undertake the time and expense of adjusting to these new rules. The proposed rule offers a better balance between costs and benefits than either the baseline or the alternative. Overall, the OCC believes that the benefits of the proposed rule justify its potential costs.

### *C. OTS Executive Order 12866 Determination*

OTS concurs with OCC's RIA. Rather than replicate that analysis, OTS drafted an RIA incorporating OCC's analysis by reference and adding appropriate material reflecting unique aspects of the thrift industry. The full text of OTS's RIA is available at the locations designated for viewing the OTS docket, which are indicated in the **ADDRESSES** section above. OTS believes that its analysis meets the requirements of Executive Order 12866. The following discussion supplements OCC's summary of its RIA.

OTS is the primary federal regulator for 826 federal- and state-chartered savings associations with assets of \$1.51 trillion as of December 31, 2007. OTS-regulated savings association assets are highly concentrated in residential mortgage-related assets, with approximately 67 percent of total assets in residential mortgage-related assets. By contrast, OCC-regulated institutions tend to concentrate their assets in commercial loans, non-interest earning deposits, and other kinds of non-mortgage loans, with only 35 percent of total assets in residential mortgage-related assets. Accordingly, OTS's analysis focuses on the impact on proposed changes to the capital treatment of residential mortgages.

### **Benefit-Cost Analysis**

Overall, OTS believes that the benefits of the proposed rule justify its costs. OTS notes, however, that measuring costs and benefits of changes in minimum capital requirements pose considerable challenges. Costs can be difficult to attribute to particular expenditures because institutions are likely to incur some of the costs as part of their ongoing efforts to improve risk measurement and management systems. The measurement of benefits is more

problematic because the benefits of the NPR are more qualitative than quantitative. Further, measurement problems exist even for those factors that ostensibly may have measurable effects, such as a lower capital requirement. Savings associations, particularly smaller institutions, generally hold capital well above regulatory minimums for a variety of reasons. Thus, the effect of reducing the regulatory capital requirement is uncertain and likely to vary across regulated savings associations. Nonetheless, OTS anticipates that a more risk sensitive allocation of regulatory capital may have a slight marginal effect on pricing and lending of adopting savings associations, but may not have a measurable effect on pricing and lending in the market at a whole.

Under OTS's analysis, direct costs and benefits include costs and benefits to the approximately 180 savings associations that opt in to the proposed rule.<sup>69</sup> Direct costs and benefits also include OTS's costs of implementing the proposed rule.

### **1. Benefits**

OTS concurs with the OCC analysis identifying the benefits associated with the proposed rule. Among the benefits cited by OCC was the enhanced risk sensitivity of minimum regulatory capital requirements. Because savings associations have a greater concentration of their assets in first-lien mortgages, the most significant change for savings associations will involve the risk weighting of residential mortgages. Under the general risk-based capital rules, most prudently underwritten residential mortgages with LTV ratios at origination of less than 90 percent are risk weighed at 50 percent. Most other residential mortgages receive a risk weight of 100 percent. Under the proposed rule, risk-weights for residential mortgages would increase as the LTV ratios increase. Thus, the benefits of opting in to the new rules will be greater for savings associations to the extent that their lending and portfolio practices include lower LTV mortgages. OTS believes that this aspect of the proposed rule is likely to be the

<sup>69</sup> OTS identified potential opt-in savings associations based on asset size, asset composition, and complexity. Specifically, OTS identified savings associations with total assets in excess of \$500 million as an appropriate threshold for opting in to the new framework. It further estimated that savings associations would opt in to the new framework if the institution has a concentration of first-lien mortgages equal to 30 percent (for savings associations with total assets between \$500 million and \$1 billion) and 20 percent (for savings associations with assets in excess of \$1 billion).

major factor in a savings association's decision to adopt the proposed rule.

## 2. Costs

OTS anticipates that the total direct costs of implementing the proposed rule will be \$143.8 million. This estimate includes direct costs of \$137.6 million for approximately 180 savings associations that would opt in to the proposed rule.<sup>70</sup> OTS further estimated that the direct costs for OTS implementation expenses would be \$6.2 million.

## 3. Uncertainty of Costs and Benefits

OTS concurs with the OCC discussion regarding the uncertainty of costs and benefits. To the extent that undesirable competitive inequities may emerge, the banking agencies have the power to respond to them through many channels, including, but not limited to suitable changes to capital adequacy regulation.

### Analysis of Baseline and Alternatives.

The OCC analysis includes a comparison between the NPR, a baseline scenario of what the world would look like without the NPR, and an alternative to the NPR. The selected alternative would require all banking organizations that are not subject to the advanced approaches rule to apply the NPR. OTS concurs in the OCC analysis and finds analogous results for savings associations. Specifically, OTS agrees with the OCC conclusion that the NPR could strengthen savings associations electing to opt in to the NPR and would not diminish the safety and soundness of savings associations that elect to forego the NPR or the advanced approaches.

### 1. Baseline Scenario

In its analysis of the baseline scenario, which would leave the current risk-based capital rules unchanged, OCC determines that national banks could avoid \$74 million of implementation-related expenditures that would otherwise be required by the NPR. As noted above, OTS estimates that 180 savings associations would spend up to \$137.6 million to implement the NPR. Retaining the current capital rules without adopting the NPR would permit these savings associations to avoid these new expenditures.

<sup>70</sup> The estimated cost per institution increased with the size of the total assets. OTS estimated that savings associations would have implementation costs of \$500,000 (for savings associations with total assets between \$500 million and \$1 billion); \$1 million (for savings associations with total assets between \$1 billion and \$10 billion); and \$5 million (for savings associations with total assets in excess of \$10 billion).

## 2. Alternative Scenario

In its analysis of the alternative scenario, OCC concludes that the aggregate benefits would considerably increase because 1,414 national banks, rather than 113, would implement the alternative. Under the alternative scenario, OTS estimates that the aggregate costs to savings associations would also increase considerably. Specifically, OTS estimates that these costs would increase from \$137.6 million (for 180 savings associations) to \$339.8 million (for 820 savings associations).<sup>71</sup>

### D. 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.

### E. Paperwork Reduction Act

#### (1) Request for Comment on Proposed Information Collection

In accordance with the requirements of the Paperwork Reduction Act of 1995, the agencies may not conduct or sponsor, and the respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number. The agencies are requesting comment on a proposed information collection. The agencies are also giving notice that the proposed collection of information has been submitted to OMB for review and approval.

Comments are invited on:

- (a) Whether the collection of information is necessary for the proper performance of the agencies' functions, including whether the information has practical utility;
- (b) The accuracy of the estimates of the burden of the information collection, including the validity of the methodology and assumptions used;
- (c) Ways to enhance the quality, utility, and clarity of the information to be collected;
- (d) Ways to minimize the burden of the information collection on respondents, including through the use of automated collection techniques or other forms of information technology; and
- (e) Estimates of capital or startup costs and costs of operation, maintenance, and purchase of services to provide information.

Commenters may submit comments on aspects of this notice that may affect

<sup>71</sup> Six of the 826 savings associations could not apply the NPR because they are subject to the advanced approaches rule.

reporting and disclosure requirements to the addresses listed in the **ADDRESSES** section of this NPR. Paperwork burden comments directed to the OCC should reference "OMB Control No. 1557-NEW" instead of the Docket ID.

#### (2) Proposed Information Collection

*Title of Information Collection:* Risk-Based Capital Guidelines; Standardized Risk-Based Capital Rules

*Frequency of Response:* event-generated and quarterly.

*Affected Public:*

*OCC:* National banks.

*Board:* State member banks and bank holding companies.

*FDIC:* Insured nonmember banks, insured state branches of foreign banks, and certain subsidiaries of these entities.

*OTS:* Savings associations and certain of their subsidiaries.

*Abstract:* The proposed rule sets forth revisions to the agencies' existing risk-based capital rules based on the provisions in the Standardized Approach for credit risk and the Basic Indicator Approach for operational risk contained in the capital adequacy framework titled "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" published by the Basel Committee on Banking Supervision in June 2004.

The new information collection requirements in the proposed rule are found in Sections 1, 37, 42, and 71. The collections of information are necessary in order to implement the proposed standardized capital adequacy framework.

Section 1 requires banking organizations to provide written notification prior to using the appendix to calculate their risk-based capital requirements (opt-in letter) or ceasing its use (opt-out letter). It also requires written notification prior to applying the principle of conservatism for a particular exposure. Section 37 requires a banking organization's prior written notification before it can calculate its own collateral haircuts using its own internal estimates. It also requires a banking organization's prior written notification before it can estimate an exposure amount for a single-product netting set of repo-style transactions and eligible margin loans when recognizing the risk-mitigating effects of financial collateral using the simple VaR methodology. The agencies believe that the notifications in Section 37 would in most cases be included in the opt-in letter discussed in Section 1. Section 42 requires certain public disclosures if a banking organization provides support

to a securitization in excess of its contractual obligation. Section 71 requires a number of qualitative and quantitative disclosures regarding a banking organization's risk-based capital ratios and their components.

*Estimated Burden:* The burden estimates below exclude any regulatory reporting burden associated with changes to the Consolidated Reports of Income and Condition for banks (FFIEC 031 and FFIEC 031; OMB Nos. 7100-0036, 3064-0052, 1557-0081), the Thrift Financial Report for thrifts (TFR; OMB No. 1550-0023), and the Financial Statements for Bank Holding Companies (FR Y-9; OMB No. 7100-0128). The agencies are still considering whether to revise these information collections or to implement a new information collection for the regulatory reporting requirements. In either case, a separate notice would be published for comment on the regulatory reporting requirements.

The burden associated with this collection of information may be summarized as follows:

#### OCC

Number of Respondents: 113.  
Estimated Burden Per Respondent:  
Opt-in letter and prior approvals, 3 hours; opt-out letter, 1 hour; and disclosures, 144 hours.

Total Estimated Annual Burden:  
16,272 hours.

#### Board

Number of Respondents: 60.  
Estimated Burden Per Respondent:  
Opt-in letter and prior approvals, 3 hours; opt-out letter, 1 hour; and disclosures, 144 hours.

Total Estimated Annual Burden: 8,880 hours.

#### FDIC

Number of Respondents: 61.  
Estimated Burden Per Respondent:  
Opt-in letter and prior approvals, 3 hours; opt-out letter, 1 hour; and disclosures, 144 hours.

Total Estimated Annual Burden: 9,032 hours.

#### OTS

Number of Respondents: 180.  
Estimated Burden Per Respondent:  
Opt-in letter, 0.5 hours; prior approvals, 2.5 hours; opt-out letter, 1 hour; and disclosures, 144 hours.

Total Estimated Annual Burden:  
26,120 hours.

The agencies' estimates represent an average across all respondents and reflect variations between institutions based on their size, complexity, and practices. Each agency is responsible for

estimating and reporting to OMB the total paperwork burden for the institutions for which they have administrative enforcement authority. They may, but are not required to, use the same methodology to determine their burden estimates.

#### F. OCC Unfunded Mandates Reform Act of 1995 Determination

The Unfunded Mandates Reform Act of 1995 (Pub. L. 104-4) (UMRA) requires cost-benefit and other analyses for a rule that would include any Federal mandate that may result in the expenditure by state, local, and tribal governments, in the aggregate, or by the private sector of \$100 million or more (adjusted annually for inflation) in any one year. The current inflation-adjusted expenditure threshold is \$119.6 million. The requirements of the UMRA include assessing a rule's effects on future compliance costs; particular regions or state, local, or tribal governments; communities; segments of the private sector; productivity; economic growth; full employment; creation of productive jobs; and the international competitiveness of U.S. goods and services. The proposed rule qualifies as a significant regulatory action under the UMRA because its Federal mandates may result in the expenditure by the private sector of \$119.6 or more in any one year. As permitted by section 202(c) of the UMRA, the required analyses have been prepared in conjunction with the Executive Order 12866 analysis document titled *Regulatory Impact Analysis for Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance; Standardized Risk-Based Capital Rules (Basel II: Standardized Option)*. The analysis is available on the Internet at <http://www.occ.treas.gov/law/basel.htm> under the link of "Regulatory Impact Analysis for Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance; Standardized Risk-Based Capital Rules (Basel II: Standardized Option), Office of the Comptroller of the Currency, International and Economic Affairs (2008)."

#### G. OTS Unfunded Mandates Reform Act of 1995 Determination

The Unfunded Mandates Reform Act of 1995 (Pub. L. 104-4) (UMRA) requires cost-benefit and other analyses for a rule that would include any Federal mandate that may result in the expenditure by state, local, and tribal governments, in the aggregate, or by the private sector of \$100 million or more (adjusted annually for inflation) in any one year. The current inflation-adjusted

expenditure threshold is \$119.6 million. The requirements of the UMRA include assessing a rule's effects on future compliance costs; particular regions or State, local, or tribal governments; communities; segments of the private sector; productivity; economic growth; full employment; creation of productive jobs; and the international competitiveness of U.S. goods and services. The proposed rule qualifies as a significant regulatory action under the UMRA because its Federal mandates may result in the expenditure by the private sector of \$119.6 or more in any one year. As permitted by section 202(c) of the UMRA, the required analyses have been prepared in conjunction with the Executive Order 12866 analysis document titled *Regulatory Impact Analysis for Risk-Based Capital Standards: Capital Adequacy Guidelines; Capital Maintenance; Domestic Capital Modifications (Basel II: Standardized Option)*. The analysis is available at the locations designated for viewing the OTS docket indicated in the **ADDRESSES** section above.

#### H. Solicitation of Comments on Use of Plain Language

Section 722 of the GLBA required 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 the rule be more clearly stated?
- 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 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?

#### Text of Common Appendix (All Agencies)

The text of the agencies' common appendix appears below:



## Appendix [ ] to Part [ ]—Capital Adequacy Guidelines for [Banks]:<sup>72</sup> Standardized Framework

### Part I General Provisions

Section 1 Purpose, Applicability, Election Procedures, and Reservation of Authority

Section 2 Definitions

Section 3 Minimum Risk-Based Capital Requirements and Overall Capital Adequacy

Section 4 Merger and Acquisition Transitional Arrangements

### Part II Qualifying Capital

Section 21 Modifications to Tier 1 and Tier 2 Capital

### Part III Risk-Weighted Assets for General Credit Risk

Section 31 Mechanics for Calculating Risk-Weighted Assets for General Credit Risk

Section 32 Inferred Ratings for General Credit Risk

Section 33 General Risk Weights

Section 34 Off-Balance Sheet Exposures

Section 35 OTC Derivative Contracts

Section 36 Guarantees and Credit Derivatives: Substitution Treatment

Section 37 Collateralized Transactions

Section 38 Unsettled Transactions

### Part IV Risk-Weighted Assets for Securitization Exposures

Section 41 Operational Requirements for Securitization Exposures

Section 42 Risk-Weighted Assets for Securitization Exposures

Section 43 Ratings-Based Approach (RBA)

Section 44 Securitization Exposures That Do Not Qualify for the RBA

Section 45 Recognition of Credit Risk Mitigants for Securitization Exposures

Section 46 Risk-Weighted Assets for Securitizations With Early Amortization Provisions

### Part V Risk-Weighted Assets for Equity Exposures

Section 51 Introduction and Exposure Measurement

Section 52 Simple Risk-Weight Approach (SRWA)

Section 53 Equity Exposures to Investment Funds

### Part VI Risk-Weighted Assets for Operational Risk

Section 61 Basic Indicator Approach

### Part VII Disclosure

Section 71 Disclosure Requirements

## Part I. General Provisions

### Section 1. Purpose, Applicability, Election Procedures, and Reservation of Authority

(a) *Purpose.* This appendix establishes:

(1) Methodologies for the calculation of risk-based capital requirements for [BANK]s that elect to use this appendix; and

(2) Operational and public disclosure requirements for such [BANK]s.

(b) *Applicability.* This appendix applies to a [BANK] that:

(1) Elects to use this appendix to calculate its risk-based capital requirements;

(2) Must use this appendix based on a determination by the [agency] under paragraph (c)(3) of this section;

(3) Is a subsidiary of or controls a depository institution that uses 12 CFR part 3, appendix D; 12 CFR part 208, appendix G; 12 CFR part 325, appendix E; or 12 CFR part 567, appendix B to calculate its risk-based capital requirements; or

(4) Is a subsidiary of a bank holding company that uses 12 CFR part 225, appendix H, to calculate its risk-based capital requirements.

(c) *Election procedures.* (1) *Opt-in procedures.* (i) Except for a [BANK] that is required under section 1(b)(1) of [the advanced approaches risk-based capital rules] to use that capital framework (other than a [BANK] that is exempt under section 1(b)(3) of [the advanced approaches risk-based capital rules]), any [BANK] may elect to use this appendix to calculate its risk-based capital requirements.

(ii) Unless otherwise waived by the [agency], a [BANK] must notify the [agency] of its intent to use this appendix in writing at least 60 days before the beginning of the calendar quarter in which it first uses this appendix. This notice must contain a list of any affiliated depository institutions or bank holding companies, if applicable, that seek not to apply this appendix under section 1(c)(2)(iii) of 12 CFR part 3, appendix D; 12 CFR part 208, appendix G; 12 CFR part 225, appendix H; 12 CFR part 325, appendix E; or 12 CFR part 567, appendix B.

(2) *Opt-out procedures.* (i) A [BANK] that uses this appendix to calculate its risk-based capital requirements may instead elect to use the [the general risk-based capital rules] or [the advanced approaches risk-based capital rules].

(ii) Unless otherwise waived by the [agency], a [BANK] must notify the [agency] of its intent to cease the use of this appendix in writing at least 60 days before the beginning of the calendar quarter in which it plans to cease the use of this appendix. Such notice must include an explanation of the [BANK]'s rationale for ceasing the use of this appendix and a statement regarding the appendix or rules the [BANK] plans to use to calculate its risk-based capital requirements.

(iii) A [BANK] that otherwise would be required to apply this appendix under paragraph (b)(3) or (b)(4) of this section may continue to use [the general risk-based capital rules] if the [agency] determines in writing that application of this appendix is not appropriate in light of the [BANK]'s asset size, level of complexity, risk profile, or scope of operations.

(3) *Supervisory application of this appendix and exclusion.* (i) The [agency] may apply this appendix to any [BANK] if the [agency] determines that application of

this appendix is appropriate in light of the [BANK]'s asset size, level of complexity, risk profile, or scope of operations.

(ii) The [agency] may exclude a [BANK] that has opted-in under paragraph (c)(1) of this section from using this appendix if the [agency] determines that application of this appendix is not appropriate in light of the [BANK]'s asset size, level of complexity, risk profile, or scope of operations.

(d) *Reservation of authority.* (1) *Additional capital in the aggregate.* The [agency] may require a [BANK] to hold an amount of capital greater than otherwise required under this appendix if the [agency] determines that the [BANK]'s risk-based capital requirement under this appendix is not commensurate with the [BANK]'s credit, market, operational, or other risks.

(2) *Risk-weighted asset amounts.* (i) If the [agency] determines that the risk-weighted asset amount calculated under this appendix by the [BANK] for one or more exposures is not commensurate with the risks associated with those exposures, the [agency] may require the [BANK] to assign a different risk-weighted asset amount to the exposure(s) or to deduct the amount of the exposure from capital.

(ii) If the [agency] determines that the risk-weighted asset amount for operational risk produced by the [BANK] under this appendix is not commensurate with the operational risks of the [BANK], the [agency] may require the [BANK] to assign a different risk-weighted asset amount for operational risk.

(3) *Other supervisory authority.* Nothing in this appendix limits the authority of the [agency] under any other provision of law or regulation to take supervisory or enforcement action, including action to address unsafe or unsound practices or conditions, deficient capital levels, or violations of law.

(e) *Notice and response procedures.* In making a determination under paragraph (c)(2)(iii), (c)(3), or (d) of this section, the [agency] will apply notice and response procedures in the same manner as the notice and response procedures in 12 CFR 3.12 (for national banks), 12 CFR 263.202 (for bank holding companies and state member banks), 12 CFR 325.6(c) (for state nonmember banks), and 12 CFR 567.3(d) (for savings associations).

(f) *Principle of conservatism.* Notwithstanding the requirements of this appendix, a [BANK] may choose not to apply a provision of this appendix to one or more exposures, provided that:

(1) The [BANK] can demonstrate on an ongoing basis to the satisfaction of the [agency] that not applying the provision would, in all circumstances, unambiguously generate a risk-based capital requirement for each such exposure greater than that which would otherwise be required under this appendix;

(2) The [BANK] appropriately manages the risk of each such exposure;

(3) The [BANK] notifies the [agency] in writing prior to applying this principle to each such exposure; and

(4) The exposures to which the [BANK] applies this principle are not, in the aggregate, material to the [BANK].

<sup>72</sup> For simplicity, and unless otherwise noted, this NPR uses the term [BANK] to include banks, savings associations, and bank holding companies. The term [agency] refers to the primary Federal supervisor of the bank applying the rule. The term [the general risk-based capital rules] refers to each agency's existing non-internal ratings based capital rules. The term [the advanced approaches risk-based capital rules] refers to each agency's existing internal ratings based capital rules. The term [the market risk rule] refers to the agencies' existing market risk capital rules.

## Section 2. Definitions

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

**Affiliate** with respect to a company means any company that controls, is controlled by, or is under common control with, the company.

**Applicable external rating.** (1) With respect to an exposure, applicable external rating means:

- (i) If the exposure has a single external rating, the external rating; and
- (ii) If the exposure has multiple external ratings, the lowest external rating.

(2) See also *external rating*.

**Applicable inferred rating.** (1) With respect to an exposure, applicable inferred rating means:

- (i) If the exposure has a single inferred rating, the inferred rating; and
- (ii) If the exposure has multiple inferred ratings, the lowest inferred rating.

(2) See also *external rating, inferred rating*.

**Asset-backed commercial paper (ABCP) program** means a program that primarily issues commercial paper that:

- (1) Has an external rating; and
- (2) Is backed by underlying exposures held in a bankruptcy-remote securitization special purpose entity (SPE).

**Asset-backed commercial paper (ABCP) program sponsor** means a [BANK] that:

- (1) Establishes an ABCP program;
- (2) Approves the sellers permitted to participate in an ABCP program;
- (3) Approves the exposures to be purchased by an ABCP program; or
- (4) Administers the ABCP program by monitoring the underlying exposures, underwriting or otherwise arranging for the placement of debt or other obligations issued by the program, compiling monthly reports, or ensuring compliance with the program documents and with the program's credit and investment policy.

**Carrying value** means, with respect to an asset, the value of the asset on the balance sheet of the [BANK] determined in accordance with generally accepted accounting principles (GAAP).

**Clean-up call** means a contractual provision that permits an originating [BANK] or servicer to call securitization exposures before their stated maturity or call date. (See also *eligible clean-up call*.)

**Commitment** means any legally binding arrangement that obligates a [BANK] to extend credit or to purchase assets.

**Commodity derivative contract** means a commodity-linked swap, purchased commodity-linked option, forward commodity-linked contract, or any other instrument linked to commodities that gives rise to similar counterparty credit risks.

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

**Control.** A person or company *controls* a company if it:

- (1) Owns, controls, or holds with power to vote 25 percent or more of a class of voting securities of the company; or
- (2) Consolidates the company for financial reporting purposes.

**Controlled early amortization provision** means an early amortization provision that meets all the following conditions:

(1) The originating [BANK] has appropriate policies and procedures to ensure that it has sufficient capital and liquidity available in the event of an early amortization;

(2) Throughout the duration of the securitization (including the early amortization period), there is the same pro rata sharing of interest, principal, expenses, losses, fees, recoveries, and other cash flows from the underlying exposures based on the originating [BANK]'s and the investors' relative shares of the underlying exposures outstanding measured on a consistent monthly basis;

(3) The amortization period is sufficient for at least 90 percent of the total underlying exposures outstanding at the beginning of the early amortization period to be repaid or recognized as in default; and

(4) The schedule for repayment of investor principal is not more rapid than would be allowed by straight-line amortization over an 18-month period.

**Corporate exposure** means a credit exposure to a natural person or a company (including an industrial development bond, an exposure to a government-sponsored entity (GSE), or an exposure to a securities broker or dealer) that is not:

- (1) An exposure to a sovereign entity, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, a multilateral development bank (MDB), a depository institution, a foreign bank, a credit union, or a public sector entity (PSE);
- (2) A regulatory retail exposure;
- (3) A residential mortgage exposure;
- (4) A pre-sold construction loan;
- (5) A statutory multifamily mortgage;
- (6) A securitization exposure; or
- (7) An equity exposure.

**Credit derivative** means a financial contract executed under standard industry credit derivative documentation that allows one party (the protection purchaser) to transfer the credit risk of one or more exposures (reference exposure) to another party (the protection provider). (See also *eligible credit derivative*.)

**Credit-enhancing interest-only strip (CEIO)** means an on-balance sheet asset that, in form or in substance:

- (1) Represents a contractual right to receive some or all of the interest and no more than a minimal amount of principal due on the underlying exposures of a securitization; and
- (2) Exposes the holder to credit risk directly or indirectly associated with the underlying exposures that exceeds a pro rata share of the holder's claim on the underlying exposures, whether through subordination provisions or other credit-enhancement techniques.

**Credit-enhancing representations and warranties** means representations and warranties that are made or assumed in connection with a transfer of underlying exposures (including loan servicing assets) and that obligate a [BANK] to protect another party from losses arising from the credit risk of the underlying exposures. Credit-

enhancing representations and warranties include provisions to protect a party from losses resulting from the default or nonperformance of the obligors of the underlying exposures or from an insufficiency in the value of the collateral backing the underlying exposures. Credit-enhancing representations and warranties do not include:

(1) Early default clauses and similar warranties that permit the return of, or premium refund clauses that cover, loans secured by a first lien on one-to-four family residential property for a period not to exceed 120 days from the date of transfer, provided that the date of transfer is within one year of origination of the residential mortgage exposure;

(2) Premium refund clauses that cover underlying exposures guaranteed, in whole or in part, by the U.S. Government, a U.S. Government Agency, or a GSE, provided that the clauses are for a period not to exceed 120 days from the date of transfer; or

(3) Warranties that permit the return of underlying exposures in instances of misrepresentation, fraud, or incomplete documentation.

**Credit risk mitigant** means collateral, a credit derivative, or a guarantee.

**Depository institution** means a depository institution as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813).

**Derivative contract** means a financial contract whose value is derived from the values of one or more underlying assets, reference rates, or indices of asset values or reference rates. Derivative contracts include interest rate derivative contracts, exchange rate derivative contracts, equity derivative contracts, commodity derivative contracts, credit derivative contracts, and any other instrument that poses similar counterparty credit risks. Derivative contracts also include unsettled securities, commodities, and foreign exchange transactions with a contractual settlement or delivery lag that is longer than the lesser of the market standard for the particular instrument or five business days.

**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:

- (1) 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); or
- (2) Leaves investors fully exposed to future draws by obligors on the underlying exposures even after the provision is triggered. (See also *controlled early amortization provision*.)

**Effective notional amount** means, for an eligible guarantee or eligible credit derivative, the lesser of the contractual notional amount of the credit risk mitigant or the exposure amount of the hedged exposure, multiplied by the percentage coverage of the credit risk mitigant. For example, the effective notional amount of an eligible

guarantee that covers, on a pro rata basis, 40 percent of any losses on a \$100 bond would be \$40.

*Eligible asset-backed commercial paper (ABCP) liquidity facility* 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. If the assets or exposures that an eligible ABCP liquidity facility is required to fund against are externally rated at the inception of the facility, the facility can be used to fund only those assets or exposures with an applicable external rating of at least investment grade at the time of funding. Notwithstanding the two preceding sentences, a liquidity facility is an eligible ABCP liquidity facility if the assets or exposures funded under the liquidity facility that do not meet the eligibility requirements are guaranteed by a sovereign entity with an issuer rating in one of the three highest investment grade rating categories.

*Eligible clean-up call* means a clean-up call that:

(1) Is exercisable solely at the discretion of the originating [BANK] or servicer;

(2) Is not structured to avoid allocating losses to securitization exposures held by investors or otherwise structured to provide credit enhancement to the securitization; and

(3)(i) For a traditional securitization, is only exercisable when 10 percent or less of the principal amount of the underlying exposures or securitization exposures (determined as of the inception of the securitization) is outstanding; or

(ii) For a synthetic securitization, is only exercisable when 10 percent or less of the principal amount of the reference portfolio of underlying exposures (determined as of the inception of the securitization) is outstanding.

*Eligible credit derivative* means a credit derivative in the form of a credit default swap, nth-to-default swap, total return swap, or any other form of credit derivative approved by the [agency], provided that:

(1) The contract meets the requirements of an eligible guarantee and has been confirmed by the protection purchaser and the protection provider;

(2) Any assignment of the contract has been confirmed by all relevant parties;

(3) If the credit derivative is a credit default swap or nth-to-default swap, the contract includes the following credit events:

(i) Failure to pay any amount due under the terms of the reference exposure, subject to any applicable minimal payment threshold that is consistent with standard market practice and with a grace period that is closely in line with the grace period of the reference exposure; and

(ii) Bankruptcy, insolvency, or inability of the obligor on the reference exposure to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due, and similar events;

(4) The terms and conditions dictating the manner in which the contract is to be settled are incorporated into the contract;

(5) If the contract allows for cash settlement, the contract incorporates a robust

valuation process to estimate loss reliably and specifies a reasonable period for obtaining post-credit event valuations of the reference exposure;

(6) If the contract requires the protection purchaser to transfer an exposure to the protection provider at settlement, the terms of at least one of the exposures that is permitted to be transferred under the contract provide that any required consent to transfer may not be unreasonably withheld;

(7) If the credit derivative is a credit default swap or nth-to-default swap, the contract clearly identifies the parties responsible for determining whether a credit event has occurred, specifies that this determination is not the sole responsibility of the protection provider, and gives the protection purchaser the right to notify the protection provider of the occurrence of a credit event; and

(8) If the credit derivative is a total return swap and the [BANK] records net payments received on the swap as net income, the [BANK] records offsetting deterioration in the value of the hedged exposure (through reductions in fair value).

*Eligible guarantee* means a guarantee from an eligible guarantor that:

(1) Is written;

(2) Is either unconditional, or a contingent obligation of the United States Government or its agencies, the validity of which to the beneficiary is dependent upon some affirmative action on the part of the beneficiary of the guarantee or a third party (for example, servicing requirements);

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

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

(5) Is not unilaterally cancelable by the protection provider for reasons other than the breach of the contract by the beneficiary;

(6) 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;

(7) 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 in a timely manner without the beneficiary first having to take legal actions to pursue the obligor for payment;

(8) Does not increase the beneficiary's cost of credit protection on the guarantee in response to deterioration in the credit quality of the reference exposure; and

(9) Is not provided by an affiliate of the [BANK], unless the affiliate is an insured depository institution, foreign bank, securities broker or dealer, or insurance company that:

(i) Does not control the [BANK]; and

(ii) Is subject to consolidated supervision and regulation comparable to that imposed on U.S. depository institutions, securities brokers or dealers, or insurance companies (as the case may be).

*Eligible guarantor* means:

(1) A sovereign entity, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, a Federal Home

Loan Bank, the Federal Agricultural Mortgage Corporation (Farmer Mac), an MDB, a depository institution, a foreign bank, a credit union, a bank holding company (as defined in section 2 of the Bank Holding Company Act (12 U.S.C. 1841)), or a savings and loan holding company (as defined in 12 U.S.C. 1467a) provided all or substantially all of the holding company's activities are permissible for a financial holding company under 12 U.S.C. 1843(k); or

(2) Any other entity (other than a SPE) if at the time the entity issued the guarantee or credit derivative or any time thereafter, the entity has issued and outstanding an unsecured debt security without credit enhancement that has an applicable external rating based on a long-term rating.

*Eligible margin loan* means an extension of credit where:

(1) The extension of credit is collateralized exclusively by liquid and readily marketable debt or equity securities, gold, or conforming residential mortgage exposures;

(2) The collateral is marked-to-market daily, and the transaction is subject to daily margin maintenance requirements;

(3) The extension of credit is conducted under an agreement that provides the [BANK] the right to accelerate and terminate the extension of credit and to liquidate or set off collateral promptly upon an event of default (including upon an event of bankruptcy, insolvency, or similar proceeding) of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions;<sup>73</sup> and

(4) The [BANK] has conducted sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review) that the agreement meets the requirements of paragraph (3) of this definition and is legal, valid, binding, and enforceable under applicable law in the relevant jurisdictions.

*Eligible servicer cash advance facility* means a servicer cash advance facility in which:

(1) The servicer is entitled to full reimbursement of advances, except that a servicer may be obligated to make non-reimbursable advances for a particular underlying exposure if any such advance is contractually limited to an insignificant amount of the outstanding principal balance of that exposure;

(2) The servicer's right to reimbursement is senior in right of payment to all other claims on the cash flows from the underlying exposures of the securitization; and

(3) The servicer has no legal obligation to, and does not, make advances to the

<sup>73</sup> This requirement is met where all transactions under the agreement are (i) executed under U.S. law and (ii) constitute "securities contracts" under section 555 of the Bankruptcy Code (11 U.S.C. 555), qualified financial contracts under section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)), or netting contracts between or among financial institutions under sections 401-407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401-4407) or the Federal Reserve Board's Regulation EE (12 CFR part 231).

securitization if the servicer concludes the advances are unlikely to be repaid.

*Equity derivative contract* means an equity-linked swap, purchased equity-linked option, forward equity-linked contract, or any other instrument linked to equities that gives rise to similar counterparty credit risks.

*Equity exposure* means:

(1) A security or instrument (whether voting or non-voting) that represents a direct or indirect ownership interest in, and is a residual claim on, the assets and income of a company, unless:

- (i) The issuing company is consolidated with the [BANK] under GAAP;
- (ii) The [BANK] is required to deduct the ownership interest from tier 1 or tier 2 capital under this appendix;
- (iii) The ownership interest incorporates a payment or other similar obligation on the part of the issuing company (such as an obligation to make periodic payments); or
- (iv) The ownership interest is a securitization exposure;

(2) A security or instrument that is mandatorily convertible into a security or instrument described in paragraph (1) of this definition;

(3) An option or warrant that is exercisable for a security or instrument described in paragraph (1) of this definition; or

(4) Any other security or instrument (other than a securitization exposure) to the extent the return on the security or instrument is based on the performance of a security or instrument described in paragraph (1) of this definition.

*Exchange rate derivative contract* means a cross-currency interest rate swap, forward foreign-exchange contract, currency option purchased, or any other instrument linked to exchange rates that gives rise to similar counterparty credit risks.

*Exposure amount* means:

(1) For the on-balance sheet component of an exposure (other than an OTC derivative contract; a repo-style transaction or an eligible margin loan for which the [BANK] determines the exposure amount under paragraph (c) or (d) of section 37 of this appendix; or a securitization exposure), exposure amount means:

(i) If the exposure is a security classified as available-for-sale, the [BANK]'s carrying value of the exposure, less any unrealized gains on the exposure, plus any unrealized losses on the exposure.

(ii) If the exposure is not a security classified as available-for-sale, the [BANK]'s carrying value of the exposure.

(2) For the off-balance sheet component of an exposure (other than an OTC derivative contract; a repo-style transaction or an eligible margin loan for which the [BANK] calculates the exposure amount under paragraph (c) or (d) of section 37 of this appendix; or a securitization exposure), exposure amount means the notional amount of the off-balance sheet component multiplied by the appropriate credit conversion factor (CCF) in section 34 of this appendix.

(3) If the exposure is an OTC derivative contract, the exposure amount determined under section 35 or 37 of this appendix.

(4) If the exposure is an eligible margin loan or repo-style transaction for which the

[BANK] calculates the exposure amount as provided in paragraph (c) or (d) of section 37 of this appendix, the exposure amount determined under section 37.

(5) If the exposure is a securitization exposure, the exposure amount determined under section 42 of this appendix.

*External rating* means a credit rating that is assigned by a nationally recognized statistical rating organization (NRSRO) to an exposure, provided:

(1) The credit rating fully reflects the entire amount of credit risk with regard to all payments owed to the holder of the exposure. If a holder is owed principal and interest on an exposure, the credit rating must fully reflect the credit risk associated with timely repayment of principal and interest. If a holder is owed only principal on an exposure, the credit rating must fully reflect only the credit risk associated with timely repayment of principal; and

(2) The credit rating is published in an accessible form and is or will be included in the transition matrices made publicly available by the NRSRO that summarize the historical performance of positions rated by the NRSRO. (See also *applicable external rating, applicable inferred rating, inferred rating, issuer rating.*)

*Financial collateral* means collateral:

(1) In the form of:

- (i) Cash on deposit with the [BANK] (including cash held for the [BANK] by a third-party custodian or trustee);
- (ii) Gold bullion;
- (iii) Long-term debt securities that have an applicable external rating of one category below investment grade or higher;
- (iv) Short-term debt instruments that have an applicable external rating of at least investment grade;
- (v) Equity securities that are publicly traded;
- (vi) Convertible bonds that are publicly traded;
- (vii) Money market mutual fund shares and other mutual fund shares if a price for the shares is publicly quoted daily; or
- (viii) Conforming residential mortgage exposures; and

(2) In which the [BANK] has a perfected, first priority security interest or, outside of the United States, the legal equivalent thereof (with the exception of cash on deposit and notwithstanding the prior security interest of any custodial agent).

*Financial standby letter of credit* means a letter of credit or similar arrangement that represents an irrevocable obligation of a [BANK] to a third-party beneficiary:

(1) To repay money borrowed by, or advanced to, or for the account of, a second party (the account party); or

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

*First-lien residential mortgage exposure* means a residential mortgage exposure secured by a first lien or a residential mortgage exposure secured by first and junior lien(s) where no other party holds an intervening lien. (See also *residential mortgage exposure.*)

*Foreign bank* means a foreign bank as defined in § 211.2 of the Federal Reserve

Board's Regulation K (12 CFR 211.2) other than a depository institution. (See also *depository institution.*)

*GAAP* means generally accepted accounting principles as used in the United States.

*Gain-on-sale* means an increase in the equity capital (as reported on Schedule RC of the Consolidated Statement of Condition and Income (Call Report), Schedule HC of the FR Y-9C Report, or Schedule SC of the Thrift Financial Report) of a [BANK] that results from a securitization (other than an increase in equity capital that results from the [BANK]'s receipt of cash in connection with the securitization). (See also *securitization.*)

*Guarantee* means a financial guarantee, letter of credit, insurance, or other similar financial instrument (other than a credit derivative) that allows one party (beneficiary) to transfer the credit risk of one or more specific exposures (reference exposure) to another party (protection provider). (See also *eligible guarantee.*)

*Inferred rating.* (1) *Securitization exposures.* A securitization exposure has an *inferred rating* equal to the external rating of the securitization exposure referenced in paragraph (1)(ii) of this definition if:

- (i) The securitization exposure does not have an external rating; and
- (ii) Another securitization exposure issued by the same obligor and secured by the same underlying exposures:

- (A) Has an external rating;
- (B) Is subordinated in all respects to the exposure with no external rating;
- (C) Does not benefit from any credit enhancement that is not available to the exposure with no external rating;
- (D) Has an effective remaining maturity that is equal to or longer than that of the exposure with no external rating; and
- (E) Is the most immediately subordinated exposure to the exposure with no external rating that meets the requirements of paragraph (1)(ii)(A) through (1)(ii)(D) of this definition.

(2) *Other exposures.* With respect to an exposure to a sovereign entity, an exposure to a PSE, or a corporate exposure, *inferred rating* means an inferred rating based on an issuer rating and an inferred rating based on a specific issue as determined under section 32 of this appendix. (See also *applicable external rating, applicable inferred rating, external rating, issuer rating.*)

*Interest rate derivative contract* means a single-currency interest rate swap, basis swap, forward rate agreement, purchased interest rate option, when-issued securities, or any other instrument linked to interest rates that gives rise to similar counterparty credit risks.

*Investing [BANK]* means, with respect to a securitization, a [BANK] that assumes the credit risk of a securitization exposure (other than an originating [BANK] of the securitization). In a typical synthetic securitization, the investing [BANK] sells credit protection on a pool of underlying exposures to the originating [BANK].

*Investment fund* means a company:

- (1) All or substantially all of the assets of which are financial assets; and
- (2) That has no material liabilities.

*Issuer rating* means a credit rating that is assigned by an NRSRO to an entity, provided:

(1) The credit rating reflects the entity's capacity and willingness to satisfy all of its financial obligations; and

(2) The credit rating is published in an accessible form and is or will be included in the transition matrices made publicly available by the NRSRO that summarize the historical performance of the NRSRO's ratings. (See also *applicable external rating, applicable inferred rating*.)

*Junior-lien residential mortgage exposure* means a residential mortgage exposure that is not a first-lien residential mortgage exposure. (See also *first-lien residential mortgage exposure, residential mortgage exposure*.)

*Main index* means the Standard & Poor's 500 Index, the FTSE All-World Index, and any other index for which the [BANK] can demonstrate to the satisfaction of the [agency] that the equities represented in the index have comparable liquidity, depth of market, and size of bid-ask spreads as equities in the Standard & Poor's 500 Index and FTSE All-World Index.

*Multi-lateral development bank (MDB)* means the International Bank for Reconstruction and Development, the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the European Investment Fund, the Nordic Investment Bank, the Caribbean Development Bank, the Islamic Development Bank, the Council of Europe Development Bank, and any other multilateral lending institution or regional development bank in which the U.S. government is a shareholder or contributing member or which the [agency] determines poses comparable credit risk.

*Nationally recognized statistical rating organization (NRSRO)* means an entity registered with the Securities and Exchange Commission (SEC) as a nationally recognized statistical rating organization under section 15E of the Securities Exchange Act of 1934 (15 U.S.C. 78o-7).

*Netting set* means a group of transactions with a single counterparty that is subject to a qualifying master netting agreement.

*Nth-to-default credit derivative* means a credit derivative that provides credit protection only for the nth-defaulting reference exposure in a group of reference exposures.

*Operational risk* means the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events (including legal risk but excluding strategic and reputational risk).

*Original maturity* with respect to an off-balance sheet commitment means the length of time between the date a commitment is issued and:

(1) For a commitment that is not subject to extension or renewal, the stated expiration date of the commitment; or

(2) For a commitment that is subject to extension or renewal, the earliest date on which the [BANK] can, at its option, unconditionally cancel the commitment.

*Originating [BANK]*, with respect to a securitization, means a [BANK] that:

(1) Directly or indirectly originated or securitized the underlying exposures included in the securitization; or

(2) Serves as an ABCP program sponsor to the securitization.

*Over-the-counter (OTC) derivative contract* means a derivative contract that is not traded on an exchange that requires the daily receipt and payment of cash-variation margin.

*Performance standby letter of credit (or performance bond)* means an irrevocable obligation of a [BANK] to pay a third-party beneficiary when a customer (account party) fails to perform on any contractual nonfinancial or commercial obligation. 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.

*Pre-sold construction loan* means any one-to-four family residential pre-sold construction loan for a residence meeting the requirements under section 618(a)(1) or (2) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 (RTCRI Act) and under 12 CFR part 3, appendix A, section 3(a)(3)(iv) (for national banks); 12 CFR part 208, appendix A, section III.C.3. (for state member banks); 12 CFR part 225, appendix A, section III.C.3. (for bank holding companies); 12 CFR part 325, appendix A, section I.I.C. (for state nonmember banks), and that is not 90 days or more past due or on nonaccrual; or 12 CFR 567.1 (definition of "qualifying residential construction loan") (for savings associations), and that is not on nonaccrual.

*Protection amount (P)* means, with respect to an exposure hedged by an eligible guarantee or eligible credit derivative, the effective notional amount of the guarantee or credit derivative as reduced to reflect any currency mismatch, maturity mismatch, or lack of restructuring coverage (as provided in section 36 of this appendix).

*Publicly traded* means traded on:

(1) Any exchange registered with the SEC as a national securities exchange under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f); or

(2) Any non-U.S.-based securities exchange that:

(i) Is registered with, or approved by, a national securities regulatory authority; and

(ii) Provides a liquid, two-way market for the instrument in question, meaning that there are enough independent bona fide offers to buy and sell so that a sales price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined promptly and a trade can be settled at such a price within five business days.

*Public sector entity (PSE)* means a state, local authority, or other governmental subdivision below the sovereign entity level.

*Qualifying master netting agreement* means any written, legally enforceable bilateral netting agreement, provided that:

(1) The agreement creates a single legal obligation for all individual transactions covered by the agreement upon an event of default, including bankruptcy, insolvency, or similar proceeding, of the counterparty;

(2) The agreement provides the [BANK] the right to accelerate, terminate, and close out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default, including upon an event of bankruptcy, insolvency, or similar proceeding, of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions;

(3) The [BANK] has conducted sufficient legal review to conclude with a well-founded basis (and has maintained sufficient written documentation of that legal review) that:

(i) The agreement meets the requirements of paragraph (2) of this definition; and

(ii) In the event of a legal challenge (including one resulting from default or from bankruptcy, insolvency, or similar proceeding) the relevant court and administrative authorities would find the agreement to be legal, valid, binding, and enforceable under the law of the relevant jurisdictions;

(4) The [BANK] establishes and maintains procedures to monitor possible changes in relevant law and to ensure that the agreement continues to satisfy the requirements of this definition; and

(5) The agreement does not contain a walkaway clause (that is, a provision that permits a non-defaulting counterparty to make a lower payment than it would make otherwise under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the agreement).

*Regulatory retail exposure* means an exposure that meets the following requirements:

(1) The [BANK]'s aggregate exposure to a single obligor does not exceed \$1 million;

(2) The exposure is part of a well diversified portfolio; and

(3) The exposure is not:

(i) An exposure to a sovereign entity, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, an MDB, a depository institution, a foreign bank, a credit union, or a PSE;

(ii) An acquisition, development, and construction loan;

(iii) A residential mortgage exposure;

(iv) A pre-sold construction loan;

(v) A statutory multifamily mortgage;

(vi) A securitization exposure;

(vii) An equity exposure; or

(viii) A debt security.

*Repo-style transaction* means a repurchase or reverse repurchase transaction, or a securities borrowing or securities lending transaction, including a transaction in which the [BANK] acts as agent for a customer and indemnifies the customer against loss, provided that:

(1) The transaction is based solely on liquid and readily marketable securities, cash, gold, or conforming residential mortgage exposures;

(2) The transaction is marked-to-market daily and subject to daily margin maintenance requirements;

(3)(i) The transaction is a “securities contract” or “repurchase agreement” under section 555 or 559, respectively, of the Bankruptcy Code (11 U.S.C. 555 or 559), a qualified financial contract under section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)), or a netting contract between or among financial institutions under sections 401–407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401–4407) or the Federal Reserve Board’s Regulation EE (12 CFR part 231); or

(ii) If the transaction does not meet the criteria in paragraph (3)(i) of this definition, then either:

(A) The transaction is executed under an agreement that provides the [BANK] the right to accelerate, terminate, and close out the transaction on a net basis and to liquidate or set off collateral promptly upon an event of default (including upon an event of bankruptcy, insolvency, or similar proceeding) of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions; or

(B) The transaction is:

(I) Either overnight or unconditionally cancelable at any time by the [BANK]; and

(II) Executed under an agreement that provides the [BANK] the right to accelerate, terminate, and close out the transaction on a net basis and to liquidate or set off collateral promptly upon an event of counterparty default; and

(4) The [BANK] has conducted sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review) that the agreement meets the requirements of paragraph (3) of this definition and is legal, valid, binding, and enforceable under applicable law in the relevant jurisdictions.

*Residential mortgage exposure* means an exposure (other than a pre-sold construction loan) that is primarily secured by one-to-four family residential property. (See also *first-lien residential mortgage exposure*, *junior-lien residential mortgage exposure*.)

*Securities and Exchange Commission (SEC)* means the U.S. Securities and Exchange Commission.

*Securitization* means a traditional securitization or a synthetic securitization.

*Securitization exposure* means an on-balance sheet or off-balance sheet credit exposure that arises from a traditional or synthetic securitization (including credit-enhancing representations and warranties). (See also synthetic securitization, traditional securitization.)

*Securitization special purpose entity (securitization SPE)* means a corporation, trust, or other entity organized for the specific purpose of holding underlying exposures of a securitization, the activities of which are limited to those appropriate to accomplish this purpose, and the structure of which is intended to isolate the underlying exposures held by the entity from the credit risk of the seller of the underlying exposures to the entity.

*Servicer cash advance facility* means a facility under which the servicer of the

underlying exposures of a securitization may advance cash to ensure an uninterrupted flow of payments to investors in the securitization, including advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the underlying exposures. (See also *eligible servicer cash advance facility*.)

*Sovereign entity* means a central government (including the U.S. Government) or an agency, department, ministry, or central bank of a central government.

*Sovereign of incorporation* means the country where an entity is incorporated, chartered, or similarly established.

*Statutory multifamily mortgage* means any multifamily residential mortgage that:

(1) Meets the requirements under section 618(b)(1) of the RTCRRI Act, and under 12 CFR part 3, appendix A, section 3(a)(3)(v) (for national banks); 12 CFR part 208, appendix A, section III.C.3. (for state member banks); 12 CFR part 225, appendix A, section III.C.3. (for bank holding companies); 12 CFR part 325, appendix A, section I.I.C. (for state nonmember banks); or 12 CFR 567.1 (definition of “qualifying multifamily mortgage loan”) and 12 CFR 567.6(a)(1)(iii) (for savings associations); and

(2) Is not on nonaccrual.

*Subsidiary* means, with respect to a company, a company controlled by that company.

*Synthetic securitization* means a transaction in which:

(1) All or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties through the use of one or more credit derivatives or guarantees (other than a guarantee that transfers only the credit risk of an individual retail exposure);

(2) The credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority;

(3) Performance of the securitization exposures depends upon the performance of the underlying exposures; and

(4) All or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities).

*Tier 1 capital* has the same meaning as in [the general risk-based capital rules], except as modified in part II of this appendix.

*Tier 2 capital* has the same meaning as in [the general risk-based capital rules], except as modified in part II of this appendix.

*Total qualifying capital* means the sum of tier 1 capital and tier 2 capital, after all deductions required in this appendix.

*Total risk-weighted assets* means the sum of a [BANK]’s:

(1) Total risk-weighted assets for general credit risk as calculated under section 31 of this appendix;

(2) Total risk-weighted assets for unsettled transactions as calculated under paragraph (f) of section 38 of this appendix;

(3) Total risk-weighted assets for securitization exposures as calculated under paragraph (b) of section 42 of this appendix;

(4) Total risk-weighted assets for equity exposures as calculated under paragraph (a) of section 52 of this appendix; and

(5) Risk-weighted assets for operational risk as calculated under section 61 of this appendix.

*Traditional securitization* means a transaction in which:

(1) All or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties other than through the use of credit derivatives or guarantees.

(2) The credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority.

(3) Performance of the securitization exposures depends upon the performance of the underlying exposures.

(4) All or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities).

(5) The underlying exposures are not owned by an operating company.

(6) The underlying exposures are not owned by a small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682).

(7)(i) For banks and bank holding companies, the underlying exposures are not owned by a firm an investment in which qualifies as a community development investment under 12 U.S.C. 24 (Eleventh); or

(ii) For savings associations, the underlying exposures are not owned by a firm an investment in which is designed primarily to promote community welfare, including the welfare of low- and moderate-income communities or families, such as by providing services or employment.

(8) The [agency] may determine that a transaction in which the underlying exposures are owned by an investment firm that exercises substantially unfettered control over the size and composition of its assets, liabilities, and off-balance sheet exposures is not a traditional securitization based on the transaction’s leverage, risk profile, or economic substance.

(9) The [agency] may deem a transaction that meets the definition of a traditional securitization, notwithstanding paragraph (5), (6), or (7) of this definition, to be a traditional securitization based on the transaction’s leverage, risk profile, or economic substance.

*Unconditionally cancelable* means with respect to a commitment that a [BANK] may, at any time, with or without cause, refuse to extend credit under the facility (to the extent permitted under applicable law).

*Underlying exposures* means one or more exposures that have been securitized in a securitization transaction.

*Value-at-Risk (VaR)* means the estimate of the maximum amount that the value of one or more exposures could decline due to market price or rate movements during a fixed holding period within a stated confidence interval.

### Section 3. Minimum Risk-Based Capital Requirements and Overall Capital Adequacy

(a) Except as modified by paragraph (c) of this section, each [BANK] must meet a minimum ratio of:

(1) Total qualifying capital to total risk-weighted assets of 8.0 percent; and

(2) Tier 1 capital to total risk-weighted assets of 4.0 percent.

(b) Each [BANK] must hold capital commensurate with the level and nature of all risks to which the [BANK] is exposed.

(c) When a [BANK] subject to [the market risk rule] calculates its risk-based capital requirements under this appendix, the [BANK] must also refer to [the market risk rule] for supplemental rules to calculate risk-based capital requirements adjusted for market risk.

(d) A [BANK] must have a rigorous process for assessing its overall capital adequacy in relation to its risk profile and a comprehensive strategy for maintaining an appropriate level of capital.

### Section 4. Merger and Acquisition Transitional Arrangements

(a) *Mergers and acquisitions of companies that use the general risk-based capital rules.* If a [BANK] that uses this appendix merges with or acquires a company that uses the general risk-based capital rules (12 CFR part 3, appendix A; 12 CFR part 208, appendix A; 12 CFR part 225, appendix A; 12 CFR part 325, appendix A; or 12 CFR part 567, subpart B), the [BANK] may use the general risk-based capital rules to calculate the risk-weighted asset amounts for, and the deductions from capital associated with, the merged or acquired company's exposures for up to 12 months after the last day of the calendar quarter during which the merger or acquisition consummates. The risk-weighted assets of the merged or acquired company calculated under the general risk-based capital rules are included in the [BANK]'s total risk-weighted assets. Deductions associated with the exposures of the merged or acquired company are deducted from the [BANK]'s tier 1 capital and tier 2 capital. If a [BANK] relies on this paragraph, the [BANK] separately must disclose publicly the amounts of risk-weighted assets and total qualifying capital calculated under this appendix for the acquiring [BANK] and under the general risk-based capital rules for the acquired company.

(b) *Mergers and acquisitions of companies that use the standardized risk-based capital rules.* If a [BANK] that uses this appendix merges with or acquires a company that uses different aspects of the standardized risk-based capital rules (12 CFR part 3, appendix D; 12 CFR part 208, appendix G; 12 CFR part 225, appendix H; 12 CFR part 325, appendix E; or 12 CFR part 567, appendix B), the [BANK] may continue to use the merged or acquired company's systems to determine the risk-weighted asset amounts for, and deductions from capital associated with, the merged or acquired company's exposures for up to 12 months after the last day of the calendar quarter during which the merger or acquisition consummates. The risk-weighted assets of the merged or acquired company are included in the [BANK]'s total risk-weighted

assets. Deductions associated with the exposures of the merged or acquired company are deducted from the [BANK]'s tier 1 capital and tier 2 capital. If a [BANK] relies on this paragraph, the [BANK] separately must disclose publicly the amounts of risk-weighted assets and total qualifying capital for the acquiring [BANK] and for the merged or acquired company under the standardized risk-based capital rules.

(c) *Mergers and acquisitions of companies that use the advanced approaches risk-based capital rules.* If a [BANK] that uses this appendix merges with or acquires a company that uses the advanced approaches risk-based capital rules (12 CFR part 3, appendix C; 12 CFR part 208, appendix F; 12 CFR part 225, appendix G; 12 CFR part 325, appendix D; or 12 CFR part 567, appendix C), the [BANK] may use the advanced approaches risk-based capital rules to determine the risk-weighted asset amounts for, and deductions from capital associated with, the merged or acquired company's exposures for up to 12 months after the last day of the calendar quarter during which the merger or acquisition consummates. During the period when the advanced approaches risk-based capital rules apply to the merged or acquired company, any ALLL associated with the merged or acquired company's exposures must be excluded from the [BANK]'s tier 2 capital. Any excess eligible credit reserves associated with the merged or acquired company's exposures may be included in the acquiring [BANK]'s tier 2 capital up to 0.6 percent of the acquired company's risk-weighted assets. (Excess eligible credit reserves must be determined according to paragraph (a)(2) of section 13 of the advanced approaches risk-based capital rules.) If a [BANK] relies on this paragraph, the [BANK] separately must disclose publicly the amounts of risk-weighted assets and qualifying capital calculated under this appendix for the acquiring [BANK] and under the advanced approaches risk-based capital rules for the acquired company.

### Part II. Qualifying Capital

#### Section 21. Modifications to Tier 1 and Tier 2 Capital

(a) *Modifications to tier 1 and tier 2 capital.* A [BANK] that uses this appendix must make the same deductions from its tier 1 capital and tier 2 capital required in [the general risk-based capital rules], except that:

(1) A [BANK] is not required to make the deductions from capital for CEIOs in 12 CFR part 3, appendix A, section 2(c)(1)(iv) (for national banks); 12 CFR part 208, appendix A, section II.B.1.e. (for state member banks); 12 CFR part 225, appendix A, section II.B.1.e. (for bank holding companies); 12 CFR part 325, appendix A, section II.B.5. (for state nonmember banks); and 12 CFR 567.5(a)(2)(iii) and 567.12(e) (for savings associations);

(2)(i) A bank or bank holding company is not required to make the deductions from capital for nonfinancial equity investments in 12 CFR part 3, appendix A, section 2(c)(1)(v) (for national banks); 12 CFR part 208, appendix A, section II.B.5. (for state member banks); 12 CFR part 225, appendix A, section

II.B.5. (for bank holding companies); and 12 CFR part 325, appendix A, section II.B. (for state nonmember banks);

(ii) A savings association is not required to deduct investments in equity securities from capital under 12 CFR 567.5(c)(2)(ii). However, it must continue to deduct equity investments in real estate under that section. See 12 CFR 567.1, which defines equity investments, including equity securities and equity investments in real estate; and

(3) A [BANK] must make the additional deductions from capital required by paragraphs (b) and (c) of this section.

(b) *Deductions from tier 1 capital.* In accordance with paragraph (a) of section 41 and paragraph (a)(1) of section 42, a [BANK] must deduct any after-tax gain-on-sale resulting from a securitization from tier 1 capital.

(c) *Deductions from tier 1 and tier 2 capital.* A [BANK] must deduct the exposures specified in paragraphs (c)(1) through (c)(3) in this section 50 percent from tier 1 capital and 50 percent from tier 2 capital. If the amount deductible from tier 2 capital exceeds the [BANK]'s actual tier 2 capital, however, the [BANK] must deduct the excess amount from tier 1 capital.

(1) *Credit-enhancing interest-only strips (CEIOS).* In accordance with paragraphs (a)(1) and (c) of section 42, any CEIO that does not constitute after-tax gain-on-sale.

(2) *Certain securitization exposures.* In accordance with paragraphs (a)(3) and (c) of section 42 and sections 43 and 44, certain securitization exposures that are required to be deducted from capital.

(3) *Certain unsettled transactions.* In accordance with paragraph (e)(3) of section 38, the [BANK]'s exposure on certain unsettled transactions.

### Part III. Risk-Weighted Assets for General Credit Risk

#### Section 31. Mechanics for Calculating Risk-Weighted Assets for General Credit Risk

A [BANK] must risk weight its assets and exposures as follows:

(a) A [BANK] must determine the exposure amount of each on-balance sheet asset, each OTC derivative contract, and each off-balance sheet commitment, trade and transaction-related contingency, guarantee, repurchase agreement, securities lending and borrowing transaction, financial standby letter of credit, forward agreement, or other similar transaction that is not:

(1) An unsettled transaction subject to section 38;

(2) A securitization exposure; or

(3) An equity exposure (other than an equity derivative contract).

(b) A [BANK] must multiply each exposure amount identified under paragraph (a) of this section by the risk weight appropriate to the exposure based on the obligor or exposure type, eligible guarantor, or financial collateral to determine the risk-weighted asset amount for each exposure.

(c) Total risk-weighted assets for general credit risk equals the sum of the risk-weighted asset amounts calculated under paragraph (b) of this section.



*Section 32. Inferred Ratings for General Credit Risk*

(a) *General.* This section describes two kinds of inferred ratings, an inferred rating based on an issuer rating and an inferred rating based on a specific issue. This section applies to an exposure to a sovereign entity, an exposure to a PSE, and a corporate exposure, except as otherwise provided in this appendix.

(b) *Inferred rating based on an issuer rating.* If a senior exposure to an obligor (that is, an exposure that ranks pari passu with an obligor's general creditors in the event of bankruptcy, insolvency, or other similar proceeding) has no external rating and the obligor has one or more issuer ratings, the senior exposure has inferred rating(s) equal to the issuer rating(s) of the obligor that reflects the currency in which the exposure is denominated.

(c) *Inferred rating based on a specific issue.* (1) An exposure with no external rating (the unrated exposure) has inferred rating(s) based on a specific issue equal to the external rating in paragraph (c)(1)(ii), if another exposure issued by the same obligor and secured by the same collateral (if any):

(i) Ranks pari passu with the unrated exposure (or at the [BANK]'s option, is subordinated in all respects to the unrated exposure);

(ii) Has an external rating based on a long-term rating;

(iii) Does not benefit from any credit enhancement that is not available to the unrated exposure;

(iv) Has an effective remaining maturity that is equal to or longer than that of the unrated exposure; and

(v) Is denominated in the same currency as the unrated exposure. This requirement does not apply where the unrated exposure is denominated in a foreign currency that arises from a [BANK]'s participation in a loan extended or guaranteed by an MDB against convertibility and transfer risk. If the [BANK]'s participation is only partially guaranteed against convertibility and transfer risk by an MDB, the [BANK] may only use the external rating denominated in the foreign currency for the portion of the participation that benefits from the MDB's guarantee.

(2) An unrated exposure has inferred rating(s) equal to the external rating(s) based on any long-term rating of low-quality exposure(s) that are issued by the same

obligor and that are senior in all respects to the unrated exposure. For the purposes of this paragraph, a low-quality exposure is an exposure that would receive a risk weight of 150 percent (for an exposure to a sovereign entity or a corporate exposure) or 100 percent or greater (for an exposure to a PSE) under section 33.

*Section 33. General Risk Weights*

(a) *Exposures to sovereign entities.* (1) A [BANK] must assign a risk weight to an exposure to a sovereign entity using the risk weight that corresponds to its applicable external or applicable inferred rating in Table 1.

(2) Notwithstanding paragraph (a)(1) of this section, a [BANK] may assign a risk weight that is lower than the applicable risk weight in Table 1 to an exposure to a sovereign entity if:

(i) The exposure is denominated in the sovereign entity's currency;

(ii) The [BANK] has at least an equivalent amount of liabilities in that currency; and

(iii) The sovereign entity allows banks under its jurisdiction to assign the lower risk weight to the same exposures to the sovereign entity.

TABLE 1.—EXPOSURES TO SOVEREIGN ENTITIES

| Applicable external or applicable inferred rating of an exposure to a sovereign entity | Example   | Risk weight (in percent) |
|--|-----------|--------------------------|
| Highest investment grade rating .....  | AAA ..... | 0                        |
| Second-highest investment grade rating .....   | AA .....  | 0                        |
| Third-highest investment grade rating .....  | A .....   | 20                       |
| Lowest investment grade rating .....   | BBB ..... | 50                       |
| One category below investment grade .....  | BB .....  | 100                      |
| Two categories below investment grade .....  | B .....   | 100                      |
| Three categories or more below investment grade .....                                  | CCC ..... | 150                      |
| No applicable rating .....   | N/A ..... | 100                      |

(b) *Certain supranational entities and multilateral development banks.* A [BANK] may assign a zero percent risk weight to an exposure to the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, or an MDB.

(c) *Exposures to depository institutions, foreign banks, and credit unions.* (1) Except as provided in paragraph (c)(2) of this

section, a [BANK] must assign a risk weight to an exposure to a depository institution, a foreign bank, or a credit union using the risk weight that corresponds to the lowest issuer rating of the entity's sovereign of incorporation in Table 2.

(2) A [BANK] must assign a risk weight of at least 100 percent to an exposure to a depository institution or a foreign bank that is includable in the depository institution's

or foreign bank's regulatory capital and that is not subject to deduction as a reciprocal holding pursuant to 12 CFR part 3, appendix A, section 2(c)(6)(ii) (national banks); 12 CFR part 208, appendix A, section II.B.3 (state member banks); 12 CFR part 225, appendix A, section II.B.3 (bank holding companies); 12 CFR part 325, appendix A, section I.B.(4) (state nonmember banks); and 12 CFR part 567.5(c)(2)(i) (savings associations).

TABLE 2.—EXPOSURES TO DEPOSITORY INSTITUTIONS, FOREIGN BANKS, AND CREDIT UNIONS

| Lowest issuer rating of the sovereign of incorporation | Example   | Risk weight (in percent) |
|--|-----------|--------------------------|
| Highest investment grade rating .....                  | AAA ..... | 20                       |
| Second-highest investment grade rating .....           | AA .....  | 20                       |
| Third-highest investment grade rating .....            | A .....   | 50                       |
| Lowest investment grade rating .....                   | BBB ..... | 100                      |
| One category below investment grade .....              | BB .....  | 100                      |
| Two categories below investment grade .....            | B .....   | 100                      |
| Three categories or more below investment grade .....  | CCC ..... | 150                      |
| No issuer rating .....                                 | N/A ..... | 100                      |

(d) *Exposures to public sector entities.* (1) Subject to the limitation in paragraph (d)(2) of this section, a [BANK]:

(i) Must risk weight an exposure to a PSE with an applicable external or applicable inferred rating based on a long-term rating

using the risk weight that corresponds to the applicable external or applicable inferred

rating based on a long-term rating in Table 3.  
 (ii) Must assign a 50 percent risk weight to an exposure to a PSE with no applicable external rating based on a long-term rating and no applicable inferred rating based on a long-term rating.

(iii) May assign a lower risk weight than would otherwise apply under Table 3 to an exposure to a foreign PSE if:  
 (A) The PSE's sovereign of incorporation allows banks under its jurisdiction to assign the lower risk weight; and  
 (B) The risk weight is not lower than the risk weight that corresponds to the lowest

issuer rating of the PSE's sovereign of incorporation in Table 1.  
 (2) A [BANK] may not assign an exposure to a PSE with no external rating a risk weight that is lower than the risk weight that corresponds to the lowest issuer rating of the PSE's sovereign of incorporation in Table 1.

TABLE 3.—EXPOSURES TO PUBLIC SECTOR ENTITIES: LONG-TERM CREDIT RATING

| Applicable external or applicable inferred rating of an exposure to a PSE | Example   | Risk weight (in percent) |
|---|-----------|--------------------------|
| Highest investment grade rating .....                                     | AAA ..... | 20                       |
| Second-highest investment grade rating .....                              | AA .....  | 20                       |
| Third-highest investment grade rating .....                               | A .....   | 50                       |
| Lowest investment grade rating .....                                      | BBB ..... | 50                       |
| One category below investment grade .....                                 | BB .....  | 100                      |
| Two categories below investment grade .....                               | B .....   | 100                      |
| Three categories or more below investment grade .....                     | CCC ..... | 150                      |
| No applicable rating .....  | N/A ..... | 50                       |

(e) *Corporate exposures.* A [BANK] must use one of the following approaches to assign risk weights to corporate exposures:

(1) *100 percent risk weight approach.* A [BANK] that chooses this approach must assign a 100 percent risk weight to all corporate exposures.

(2) *Ratings approach.* (i) Subject to the limitations in paragraph (e)(2)(ii) of this section, a [BANK] that chooses this approach:

(A) Must assign a risk weight to a corporate exposure with an applicable external or applicable inferred rating based on a long-term rating using the risk weight that

corresponds to the applicable external or applicable inferred rating based on a long-term rating in Table 4.

(B) Must assign a risk weight to a corporate exposure with an applicable external rating based on a short-term rating using the risk weight that corresponds to the applicable external rating based on a short-term rating in Table 5.

(C) Must assign a 100 percent risk weight to all corporate exposures with no external rating and no inferred rating.

(ii) *Limitations.* (A) A [BANK] may not assign a corporate exposure with no external

rating a risk weight that is lower than the risk weight that corresponds to the lowest issuer rating of the obligor's sovereign of incorporation in Table 1.

(B) If an obligor has any exposure with an external rating based on a short-term rating that corresponds to a risk weight of 150 percent under Table 5, a [BANK] must assign a 150 percent risk weight to a corporate exposure to that obligor with no external rating and that ranks *pari passu* with or is subordinated to the externally rated exposure.

TABLE 4.—CORPORATE EXPOSURES: LONG-TERM CREDIT RATING

| Applicable external or applicable inferred rating of the corporate exposure | Example   | Risk weight (in percent) |
|---|-----------|--------------------------|
| Highest investment grade rating .....                                       | AAA ..... | 20                       |
| Second-highest investment grade rating .....                                | AA .....  | 20                       |
| Third-highest investment grade rating .....                                 | A .....   | 50                       |
| Lowest investment grade rating .....  | BBB ..... | 100                      |
| One category below investment grade .....                                   | BB .....  | 100                      |
| Two categories below investment grade .....                                 | B .....   | 150                      |
| Three categories or more below investment grade .....                       | CCC ..... | 150                      |
| No applicable rating .....  | N/A ..... | 100                      |

TABLE 5.—CORPORATE EXPOSURES: SHORT-TERM CREDIT RATING

| Applicable external rating of the corporate exposure | Example                  | Risk weight (in percent) |
|--|--------------------------|--------------------------|
| Highest investment grade rating .....                | A-1/P-1 .....            | 20                       |
| Second-highest investment grade rating .....         | A-2/P-2 .....            | 50                       |
| Third-highest investment grade rating .....          | A-3/P-3 .....            | 100                      |
| Below investment grade .....                         | B, C and non-prime ..... | 150                      |
| No applicable external rating .....                  | N/A .....                | 100                      |

(f) *Regulatory retail exposures.* A [BANK] must assign a 75 percent risk weight to a regulatory retail exposure.

(g) *Residential mortgage exposures.* (1) *First-lien residential mortgage exposures.* (i) A [BANK] must assign the applicable risk weight in Table 6, using the loan-to-value ratio (LTV ratio) as described in paragraph (g)(3) of this section, to a first-lien residential

mortgage exposure that is secured by property that is owner-occupied or rented, is prudently underwritten, is not 90 days or more past due, and is not on nonaccrual. A first-lien residential mortgage exposure that has been restructured may receive a risk weight lower than 100 percent only if the [BANK] updates the LTV ratio at the time of

restructuring as provided under paragraph (g)(3) of this section.

(ii) If a first-lien residential mortgage exposure does not satisfy these requirements, the [BANK] must assign a 100 percent risk weight to the exposure if the LTV ratio is 90 percent or less, and must assign a 150 percent risk weight if the LTV ratio is greater than 90 percent.

TABLE 6.—RISK WEIGHTS FOR FIRST-LIEN RESIDENTIAL MORTGAGE EXPOSURES

| Loan-to-value ratio (in percent)                   | Risk weight (in percent) |
|--|--------------------------|
| Less than or equal to 60 .....                     | 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                      |

(2) *Junior-lien residential mortgage exposures.* (i) A [BANK] must assign the applicable risk weight in Table 7, using the LTV ratio described in paragraph (g)(3) of this section, to a junior-lien residential mortgage exposure that is not 90 days or more past due or on nonaccrual.

(ii) If a junior-lien residential mortgage exposure is 90 days or more past due or on nonaccrual, a [BANK] must assign a 150 percent risk weight to the exposure.

TABLE 7.—RISK WEIGHTS FOR JUNIOR-LIEN RESIDENTIAL MORTGAGE EXPOSURES

| Loan-to-value ratio (in percent)                   | Risk weight (in percent) |
|--|--------------------------|
| Less than or equal to 60 .....                     | 75                       |
| Greater than 60 and less than or equal to 90 ..... | 100                      |
| Greater than 90 .....                              | 150                      |

(3) *LTV ratio calculation.* To determine the appropriate risk weight for a residential mortgage exposure under this paragraph (g), a [BANK] must calculate the LTV ratio (that is, the loan amount of the exposure divided by the value of the property) as described in this paragraph. A [BANK] must calculate a separate LTV ratio for the funded and unfunded portions of a residential mortgage exposure and must assign a risk weight to the exposure amount of each portion according to its respective LTV ratio.

(i) *Loan amount for calculating the LTV ratio of the funded portion of a residential mortgage exposure.*

(A) *First-lien residential mortgage exposure.* The loan amount of the funded portion of a first-lien residential mortgage exposure is the principal amount of the exposure.

(B) *Junior-lien residential mortgage exposure.* The loan amount of the funded portion of a junior-lien residential mortgage exposure is the principal amount of the exposure plus the principal amounts of all senior exposures secured by the same residential property on the date of origination of the junior-lien residential mortgage exposure plus the unfunded portion of the maximum contractual amount of any senior exposure(s) secured by the same residential property.

(ii) *Loan amount for calculating the LTV ratio of the unfunded portion of a residential mortgage exposure.* The loan amount of the unfunded portion of a residential mortgage exposure is:

(A) The amount calculated under paragraph (g)(3)(i) of this section; plus

(B) The unfunded portion of the maximum contractual amount of the exposure.

(iii) *PMI.* A [BANK] may reduce the loan amount in the LTV ratio up to the amount covered by loan-level private mortgage insurance (PMI). The loan-level PMI must protect the [BANK] in the event of borrower default up to a predetermined amount of the residential mortgage exposure, and may not have a pool-level cap that would effectively reduce coverage below the predetermined amount of the exposure. Loan-level PMI must be provided by a regulated mortgage insurance company that is not an affiliate of the [BANK], and that:

(A) Has issued long-term senior debt (without credit enhancement) that has an external rating that is in at least the third-highest investment grade rating category; or

(B) Has a claims-paying rating that is in at least the third-highest investment grade rating category.

(iv) *Value.* (A) The value of the property is the lesser of the actual acquisition cost (for a purchase transaction) or the estimate of the property's value at the origination of the loan or, at the [BANK]'s option, at the time of restructuring.

(B) A [BANK] must base all estimates of a property's value on an appraisal or evaluation of the property that satisfies subpart C of 12 CFR part 34 (national banks); subpart E of 12 CFR part 208 (state member banks); 12 CFR part 323 (state nonmember banks); and 12 CFR part 564 (savings associations).

(h) *Pre-sold residential construction loans.* A [BANK] must assign a 50 percent risk weight to a pre-sold construction loan unless the purchase contract is cancelled. A [BANK] must assign a 100 percent risk weight to such loan if the purchase contract is cancelled.

(i) *Statutory multifamily mortgages.* A [BANK] must assign a 50 percent risk weight to a statutory multifamily mortgage.

(j) *Past due exposures.* Except for a residential mortgage exposure, if an exposure is 90 days or more past due or on nonaccrual:

(1) A [BANK] must assign a 150 percent risk weight to the portion of the exposure that does not have a guarantee or that is unsecured.

(2) A [BANK] may assign a risk weight to the collateralized portion of the exposure based on the risk weight of the collateral under this section if the collateral meets the requirements of paragraph (b)(1) of section 37 of this appendix.

(3) A [BANK] may assign a risk weight to the guaranteed portion of the exposure based on the risk weight that would apply under section 36 of this appendix if the guarantee or credit derivative meets the requirements of that section.

(k) *Other assets.* (1) A [BANK] may assign a zero percent risk weight to cash owned and held in all offices of the [BANK] or in transit; to gold bullion held in the [BANK]'s own vaults or held in another depository

institution's vaults on an allocated basis, to the extent the gold bullion assets are offset by gold bullion liabilities; and to derivative contracts that are publicly traded on an exchange that requires the daily receipt and payment of cash-variation margin.

(2) A [BANK] may assign a 20 percent risk weight to cash items in the process of collection.

(3) A [BANK] must apply a 100 percent risk weight to all assets not specifically assigned a different risk weight under this appendix (other than exposures that are deducted from tier 1 or tier 2 capital).

*Section 34. Off-Balance Sheet Exposures*

(a) *General.* (1) A [BANK] must calculate the exposure amount of an off-balance sheet exposure using the credit conversion factors (CCFs) in paragraph (b) of this section.

(2) Where a [BANK] commits to provide a commitment, the [BANK] may apply the lower of the two applicable CCFs.

(3) Where a [BANK] provides a commitment structured as a syndication or participation, the [BANK] is only required to calculate the exposure amount for its pro rata share of the commitment.

(b) *Credit conversion factors.* (1) *Zero percent CCF.* A [BANK] must apply a zero percent CCF to the unused portion of commitments that are unconditionally cancelable.

(2) *20 percent CCF.* A [BANK] must apply a 20 percent CCF to the following off-balance-sheet exposures:

(i) Commitments with an original maturity of one year or less that are not unconditionally cancelable.

(ii) Self-liquidating, trade-related contingent items that arise from the movement of goods, with an original maturity of one year or less.

(3) *50 percent CCF.* A [BANK] must apply a 50 percent CCF to the following off-balance-sheet exposures:

(i) Commitments with an original maturity of more than one year that are not unconditionally cancelable by the [BANK].

(ii) Transaction-related contingent items, including performance bonds, bid bonds, warranties, and performance standby letters of credit.

(4) *100 percent CCF.* A [BANK] must apply a 100 percent CCF to the following off-balance-sheet items and other similar transactions:

(i) Guarantees;

(ii) Repurchase agreements (the off-balance sheet component of which equals the sum of the current market values of all positions the [BANK] has sold subject to repurchase);

(iii) Off-balance sheet securities lending transactions (the off-balance sheet component of which equals the sum of the current market values of all positions the [BANK] has lent under the transaction);

(iv) Off-balance sheet securities borrowing transactions (the off-balance sheet component of which equals the sum of the current market values of all non-cash positions the [BANK] has posted as collateral under the transaction);

(v) Financial standby letters of credit; and

(vi) Forward agreements. Forward agreements are legally binding contractual

obligations to purchase assets with certain drawdown at a specified future date. Such obligations do not include commitments to make residential mortgage loans or forward foreign exchange contracts.

**Section 35. OTC Derivative Contracts**

A [BANK] must calculate the exposure amount of an OTC derivative contract under this section.

(a) A [BANK] must determine the exposure amount for an OTC derivative contract that is not subject to a qualifying master netting agreement using the single OTC derivative contract calculation in paragraph (c) of this section.

(b) A [BANK] must determine the exposure amount for multiple OTC derivative contracts that are subject to a qualifying master netting agreement using the multiple OTC derivative contracts calculation in paragraph (d) of this section.

(c) *Single OTC derivative contract.* Except as modified by paragraph (e) of this section, the exposure amount for a single OTC derivative contract that is not subject to a qualifying master netting agreement is equal to the sum of the [BANK]'s current credit exposure and potential future credit exposure (PFE) on the derivative contract.

(1) *Current credit exposure.* The current credit exposure for a single OTC derivative contract is the greater of the mark-to-market value of the derivative contract or zero.

(2) *PFE.* The PFE for a single OTC derivative contract, including an OTC derivative contract with a negative mark-to-market value, is calculated by multiplying the notional principal amount of the derivative contract by the appropriate conversion factor in Table 8. For purposes of calculating either the PFE under this paragraph or the gross PFE under paragraph

(d) of this section for exchange rate contracts and other similar contracts in which the notional principal amount is equivalent to the cash flows, notional principal amount is the net receipts to each party falling due on each value date in each currency. For any OTC derivative contract that does not fall within one of the specified categories in Table 8, the PFE must be calculated using the appropriate "other" conversion factor. A [BANK] must use an OTC derivative contract's effective notional principal amount (that is, its apparent or stated notional principal amount multiplied by any multiplier in the OTC derivative contract) rather than its apparent or stated notional principal amount in calculating PFE. PFE of the protection provider of a credit derivative is capped at the net present value of the amount of unpaid premiums.

**TABLE 8.—CONVERSION FACTOR MATRIX FOR OTC DERIVATIVE CONTRACTS <sup>1</sup>**

| Remaining maturity <sup>2</sup>                                  | Interest rate | Foreign exchange rate and gold | Credit (investment-grade reference obligor) <sup>3</sup> | Credit (non-investment-grade reference obligor) | Equity | Precious metals (except gold) | Other |
|--|---------------|--------------------------------|--|---|--------|-------------------------------|-------|
| One year or less .....   | 0.00          | 0.01                           | 0.05   | 0.10  | 0.06   | 0.07                          | 0.10  |
| Greater than one year and less than or equal to five years ..... | 0.005         | 0.05                           | 0.05   | 0.10  | 0.08   | 0.07                          | 0.12  |
| Greater than five years .....                                    | 0.015         | 0.075                          | 0.05   | 0.10  | 0.10   | 0.08                          | 0.15  |

<sup>1</sup> For an OTC derivative contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the derivative contract.

<sup>2</sup> For an OTC derivative contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the contract is zero, the remaining maturity equals the time until the next reset date. For an interest rate derivative contract with a remaining maturity of greater than one year that meets these criteria, the minimum conversion factor is 0.005.

<sup>3</sup> A [BANK] must use the column labeled "Credit (investment-grade reference obligor)" for a credit derivative whose reference obligor has an outstanding unsecured debt security that has an applicable external rating based on a long-term rating of at least investment grade without credit enhancement. A [BANK] must use the column labeled "Credit (non-investment grade reference obligor)" for all other credit derivatives.

(d) *Multiple OTC derivative contracts subject to a qualifying master netting agreement.* Except as modified by paragraph (e) of this section, the exposure amount for multiple OTC derivative contracts subject to a qualifying master netting agreement is equal to the sum of the net current credit exposure and the adjusted sum of the PFE for all OTC derivative contracts subject to the qualifying master netting agreement.

(1) *Net current credit exposure.* The net current credit exposure is the greater of the net sum of all positive and negative mark-to-market values of the individual OTC derivative contracts subject to the qualifying master netting agreement or zero.

(2) *Adjusted sum of the PFE.* The adjusted sum of the PFE, *Anet*, is calculated as  $Anet = (0.4 \times Agross) + (0.6 \times NGR \times Agross)$ , Where:

- (i) *Agross* = the gross PFE (that is, the sum of the PFE amounts (as determined under paragraph (c)(2) of this section) for each individual OTC derivative contract subject to the qualifying master netting agreement); and
- (ii) *NGR* = the net to gross ratio (that is, the ratio of the net current credit exposure to the gross current credit exposure). In

calculating the NGR, the gross current credit exposure equals the sum of the positive current credit exposures (as determined under paragraph (c)(1) of this section) of all individual OTC derivative contracts subject to the qualifying master netting agreement.

(e) *Collateralized OTC derivative contracts.* A [BANK] may recognize the credit risk mitigation benefits of financial collateral that secures an OTC derivative contract or multiple OTC derivatives subject to a qualifying master netting agreement (netting set) by using the simple approach in paragraph (b) of section 37 of this appendix. Alternatively, a [BANK] may recognize the credit risk mitigation benefits of financial collateral that secures such a contract or netting set if the financial collateral is marked-to-market on a daily basis and subject to a daily margin maintenance requirement by applying a risk weight to the exposure as if it is uncollateralized and adjusting the exposure amount calculated under paragraph (c) or (d) of this section using the collateral haircut approach in paragraph (c) of section 37 of this appendix. The [BANK] must substitute the exposure amount calculated under paragraph (c) or (d) of this section for  $\Sigma E$  in the equation in

paragraph (c)(3) of section 37 and must use a 10-business-day minimum holding period ( $T_M = 10$ ).

(f) *Counterparty credit risk for credit derivatives.* (1) A [BANK] that purchases a credit derivative that is recognized under section 36 of this appendix as a credit risk mitigant for an exposure that is not a covered position under [the market risk rule] is not required to compute a separate counterparty credit risk capital requirement under section 31 of this appendix provided that the [BANK] does so consistently for all such credit derivatives and either includes all or excludes all such credit derivatives that are subject to a qualifying master netting agreement from any measure used to determine counterparty credit risk exposure to all relevant counterparties for risk-based capital purposes.

(2) A [BANK] that is the protection provider in a credit derivative must treat the credit derivative as an exposure to the reference obligor and is not required to compute a counterparty credit risk capital requirement for the credit derivative under section 31 of this appendix provided that it does so consistently for all such credit derivatives and either includes all or excludes all such credit derivatives that are

subject to a qualifying master netting agreement from any measure used to determine counterparty credit risk exposure to all relevant counterparties for risk-based capital purposes (unless the [BANK] is treating the credit derivative as a covered position under [the market risk rule], in which case the [BANK] must compute a supplemental counterparty credit risk capital requirement under this section).

(g) *Counterparty credit risk for equity derivatives.* (1) A [BANK] must treat an equity derivative contract as an equity exposure and compute a risk-weighted asset amount for the equity derivative contract under part V of this appendix (unless the [BANK] is treating the contract as a covered position under [the market risk rule]).

(2) In addition, the [BANK] must also calculate a risk-based capital requirement for the counterparty credit risk of an equity derivative contract under this part if the [BANK] is treating the contract as a covered position under [the market risk rule].

(3) If the [BANK] risk weights the contract under the Simple Risk-Weight Approach (SRWA) in section 52 of this appendix, a [BANK] may choose not to hold risk-based capital against the counterparty credit risk of the equity derivative contract, as long as it does so for all such contracts. Where the equity derivative contracts are subject to a qualified master netting agreement, a [BANK] using the SRWA must either include all or exclude all of the contracts from any measure used to determine counterparty credit risk exposure.

#### *Section 36. Guarantees and Credit Derivatives: Substitution Treatment*

(a) *Scope.* (1) *General.* A [BANK] may recognize the credit risk mitigation benefits of an eligible guarantee or eligible credit derivative by substituting the risk weight associated with a protection provider for the risk weight assigned to an exposure, as provided under this section.

(2) This section applies to exposures for which:

- (i) Credit risk is fully covered by an eligible guarantee or eligible credit derivative; or
- (ii) Credit risk is covered on a pro rata basis (that is, on a basis in which the [BANK] and the protection provider share losses proportionately) by an eligible guarantee or eligible credit derivative.

(3) Exposures on which there is a tranching of credit risk (reflecting at least two different levels of seniority) generally are securitization exposures subject to the securitization framework in part IV of this appendix.

(4) If multiple eligible guarantees or eligible credit derivatives cover a single exposure described in paragraph (a)(2) of this section, a [BANK] may treat the hedged exposure as multiple separate exposures each covered by a single eligible guarantee or eligible credit derivative and may calculate a separate risk-weighted asset amount for each separate exposure as described in paragraph (c) of this section.

(5) If a single eligible guarantee or eligible credit derivative covers multiple hedged exposures described in paragraph (a)(2) of this section, a [BANK] must treat each

hedged exposure as covered by a separate eligible guarantee or eligible credit derivative and must calculate a separate risk-weighted asset amount for each exposure as described in paragraph (c) of this section.

(6) If a [BANK] calculates the risk-weighted asset amount under section 31 for an exposure whose applicable external or applicable inferred rating reflects the benefits of a credit risk mitigant provided to the exposure, the [BANK] may not use the credit risk mitigation rules in this section to further reduce the risk-weighted asset amount for the exposure to reflect that credit risk mitigant.

(b) *Rules of recognition.* (1) A [BANK] may only recognize the credit risk mitigation benefits of eligible guarantees and eligible credit derivatives.

(2) A [BANK] may only recognize the credit risk mitigation benefits of an eligible credit derivative to hedge an exposure that is different from the credit derivative's reference exposure used for determining the derivative's cash settlement value, deliverable obligation, or occurrence of a credit event if:

(i) The reference exposure ranks *pari passu* with or is subordinated to the hedged exposure; and

(ii) The reference exposure and the hedged exposure are to the same legal entity, and legally enforceable cross-default or cross-acceleration clauses are in place to assure payments under the credit derivative are triggered when the obligor fails to pay under the terms of the hedged exposure.

(c) *Substitution approach.* (1) *Full coverage.* If an eligible guarantee or eligible credit derivative meets the conditions in paragraphs (a) and (b) of this section and the protection amount (P) of the guarantee or credit derivative is greater than or equal to the exposure amount of the hedged exposure, a [BANK] may recognize the guarantee or credit derivative in determining the risk-weighted asset amount for the hedged exposure by substituting the risk weight applicable to the guarantee or credit derivative under section 33 for the risk weight assigned to the exposure. If the [BANK] determines that full substitution under this paragraph leads to an inappropriate degree of risk mitigation, the [BANK] may substitute a higher risk weight than that applicable to the guarantee or credit derivative.

(2) *Partial coverage.* If an eligible guarantee or eligible credit derivative meets the conditions in paragraphs (a) and (b) of this section and the protection amount (P) of the guarantee or credit derivative is less than the exposure amount of the hedged exposure, the [BANK] must treat the hedged exposure as two separate exposures (protected and unprotected) in order to recognize the credit risk mitigation benefit of the guarantee or credit derivative.

(i) The [BANK] may calculate the risk-weighted asset amount for the protected exposure under section 31 of this appendix, where the applicable risk weight is the risk weight applicable to the guarantee or credit derivative. If the [BANK] determines that full substitution under this paragraph leads to an inappropriate degree of risk mitigation, the [BANK] may use a higher risk weight than

that applicable to the guarantee or credit derivative.

(ii) The [BANK] must calculate the risk-weighted asset amount for the unprotected exposure under section 31 of this appendix, where the applicable risk weight is that of the hedged exposure.

(iii) The treatment in this paragraph (c)(2) is applicable when the credit risk of an exposure is covered on a partial pro rata basis and may be applicable when an adjustment is made to the effective notional amount of the guarantee or credit derivative under paragraph (d), (e), or (f) of this section.

(d) *Maturity mismatch adjustment.* (1) A [BANK] that recognizes an eligible guarantee or eligible credit derivative in determining the risk-weighted asset amount for a hedged exposure must adjust the effective notional amount of the credit risk mitigant to reflect any maturity mismatch between the hedged exposure and the credit risk mitigant.

(2) A maturity mismatch occurs when the residual maturity of a credit risk mitigant is less than that of the hedged exposure(s).

(3) The residual maturity of a hedged exposure is the longest possible remaining time before the obligor is scheduled to fulfil its obligation on the exposure. If a credit risk mitigant has embedded options that may reduce its term, the [BANK] (protection purchaser) must use the shortest possible residual maturity for the credit risk mitigant. If a call is at the discretion of the protection provider, the residual maturity of the credit risk mitigant is at the first call date. If the call is at the discretion of the [BANK] (protection purchaser), but the terms of the arrangement at origination of the credit risk mitigant contain a positive incentive for the [BANK] to call the transaction before contractual maturity, the remaining time to the first call date is the residual maturity of the credit risk mitigant. For example, where there is a step-up in cost in conjunction with a call feature or where the effective cost of protection increases over time even if credit quality remains the same or improves, the residual maturity of the credit risk mitigant will be the remaining time to the first call.

(4) A credit risk mitigant with a maturity mismatch may be recognized only if its original maturity is greater than or equal to one year and its residual maturity is greater than three months.

(5) When a maturity mismatch exists, the [BANK] must apply the following adjustment to reduce the effective notional amount of the credit risk mitigant:

$$P_m = E \times (t - 0.25) / (T - 0.25),$$

where:

- (i)  $P_m$  = effective notional amount of the credit risk mitigant, adjusted for maturity mismatch;
- (ii)  $E$  = effective notional amount of the credit risk mitigant;
- (iii)  $t$  = the lesser of  $T$  or the residual maturity of the credit risk mitigant, expressed in years; and
- (iv)  $T$  = the lesser of five or the residual maturity of the hedged exposure, expressed in years.

(e) *Adjustment for credit derivatives without restructuring as a credit event.* If a [BANK] recognizes an eligible credit

derivative that does not include as a credit event a restructuring of the hedged exposure involving forgiveness or postponement of principal, interest, or fees that results in a credit loss event (that is, a charge-off, specific provision, or other similar debit to the profit and loss account), the [BANK] must apply the following adjustment to reduce the effective notional amount of the credit derivative:

$$P_r = P_m \times 0.60,$$

where:

- (1)  $P_r$  = effective notional amount of the credit risk mitigant, adjusted for lack of restructuring event (and maturity mismatch, if applicable); and
- (2)  $P_m$  = effective notional amount of the credit risk mitigant (adjusted for maturity mismatch, if applicable).

(f) *Currency mismatch adjustment.* (1) If a [BANK] recognizes an eligible guarantee or eligible credit derivative that is denominated in a currency different from that in which the hedged exposure is denominated, the [BANK] must apply the following formula to the effective notional amount of the guarantee or credit derivative:

$$P_c = P_r \times (1 - H_{FX}),$$

where:

- (i)  $P_c$  = effective notional amount of the credit risk mitigant, adjusted for currency mismatch (and maturity mismatch and lack of restructuring event, if applicable);
- (ii)  $P_r$  = effective notional amount of the credit risk mitigant (adjusted for maturity mismatch and lack of restructuring event, if applicable); and
- (iii)  $H_{FX}$  = haircut appropriate for the currency mismatch between the credit risk mitigant and the hedged exposure.

(2) A [BANK] must set  $H_{FX}$  equal to eight percent unless it qualifies for the use of and uses its own internal estimates of foreign exchange volatility based on a 10-business-day holding period and daily marking-to-market and remargining. A [BANK] qualifies for the use of its own internal estimates of foreign exchange volatility if it qualifies for:

- (i) The own-estimates haircuts in paragraph (c)(5) of section 37; or
- (ii) The simple VaR methodology in paragraph (d) of section 37.

(3) A [BANK] must adjust  $H_{FX}$  calculated in paragraph (f)(2) of this section upward if the [BANK] revalues the guarantee or credit derivative less frequently than once every 10 business days using the following square root of time formula:

$$H_M = H_N \sqrt{\frac{T_M}{T_N}},$$

where:

- (i)  $T_M$  equals the greater of 10 or the number of days between revaluation;
- (ii)  $T_N$  equals the holding period used by the [BANK] to derive  $H_N$ ; and
- (iii)  $H_N$  equals the haircut based on the holding period  $T_N$ .

#### Section 37. Collateralized Transactions

(a) *General.* (1) This section provides three approaches that a [BANK] may use to recognize the risk-mitigating effects of financial collateral:

(i) *The simple approach.* A [BANK] may use the simple approach for any exposure.

(ii) *The collateral haircut approach.* A [BANK] may use the collateral haircut approach for repo-style transactions, eligible margin loans, collateralized OTC derivative contracts, and single-product netting sets of such transactions.

(iii) *The simple VaR methodology.* A [BANK] may use the simple VaR methodology for single-product netting sets of repo-style transactions and eligible margin loans.

(2) A [BANK] may use any approach described in this section that is valid for a particular type of exposure or transaction; however, it must use the same approach for similar exposures or transactions.

(3) If a [BANK] calculates its risk-weighted asset amount under section 31 for an exposure whose applicable external or applicable inferred rating reflects the benefits of financial collateral to the exposure, the [BANK] may not use the credit risk mitigation rules in this section to further reduce the risk-weighted asset amount for the exposure to reflect that financial collateral.

(b) *The simple approach.* (1) *General requirements.* (i) A [BANK] may recognize the credit risk mitigation benefits of financial collateral that secures any exposure or any collateral that secures a repo-style transaction that is included in the [BANK]'s VaR-based measure under [the market risk rule].

(ii) To qualify for the simple approach the collateral must meet the following requirements:

(A) The collateral must be subject to a collateral agreement for at least the life of the exposure;

(B) The collateral must be revalued at least every six months; and

(C) The collateral (other than gold) and the exposure must be denominated in the same currency.

(2) *Risk weight substitution.* (i) A [BANK] may risk weight the portion of an exposure that is secured by the market value of collateral (that meets the requirements of paragraph (b)(1) of this section) based on the risk weight assigned to the collateral under this appendix. For repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions, the collateral is the instruments, gold, and cash the [BANK] has borrowed, purchased subject to resale, or taken as collateral from the counterparty under the transaction. Except as provided in paragraph (b)(3) of this section, the risk weight assigned to the collateralized portion of the exposure may not be less than 20 percent.

(ii) A [BANK] must risk weight the unsecured portion of the exposure based on the risk weight assigned to the exposure under this appendix.

(3) *Exceptions to the 20 percent risk-weight floor and other requirements.*

Notwithstanding paragraph (b)(2)(i) of this section:

(i) A [BANK] may assign a zero percent risk weight to an exposure to an OTC derivative contract that is marked-to-market on a daily basis and subject to a daily margin maintenance requirement, to the extent the contract is collateralized by cash on deposit.

(ii) A [BANK] may assign a 10 percent risk weight to an exposure to an OTC derivative contract that is marked-to-market on a daily basis and subject to a daily margin maintenance requirement, to the extent that the contract is collateralized by a sovereign security or a PSE security that qualifies for a zero percent risk weight under section 33 of this appendix.

(iii) A [BANK] may assign a zero percent risk weight to the collateralized portion of an exposure where:

(A) The financial collateral is cash on deposit; or

(B) The financial collateral is a sovereign security or a PSE security, the security qualifies for a zero percent risk weight under section 33, and the [BANK] has discounted the market value of the collateral by 20 percent.

(iv) If a [BANK] recognizes collateral in the form of a conforming residential mortgage, the [BANK] must risk weight the portion of the exposure that is secured by the conforming residential mortgage at 50 percent.

(c) *Collateral haircut approach.* (1) *General.* A [BANK] may recognize the credit risk mitigation benefits of financial collateral that secures an eligible margin loan, repo-style transaction, collateralized OTC derivative contract, or single-product netting set of such transactions, and of any collateral that secures a repo-style transaction that is included in the [BANK]'s VaR-based measure under [the market risk rule] by using the collateral haircut approach in this paragraph (c).

(2) *Approaches for the calculation of collateral haircuts.* There are two ways to calculate collateral haircuts: the standard supervisory haircuts approach and the own internal estimates for haircuts approach. For exposures other than repo-style transactions included in the [BANK]'s VaR-based measure under the [the market risk rule], a [BANK] must use the standard supervisory haircut approach with a minimum 10-business-day holding period if it chooses to recognize in the exposure amount the benefits of collateral in the form of a conforming residential mortgage.

(3) *Exposure amount equation.* Under either collateral haircut approach, a [BANK] must determine the exposure amount for an eligible margin loan, repo-style transaction, collateralized OTC derivative contract, or a single-product netting set of such transactions by setting the exposure amount equal to  $\max\{0, [(\Sigma E - \Sigma C) + \Sigma(Es \times Hs) + \Sigma(Efx \times Hfx)]\}$ , where:

(i)(A) For eligible margin loans and repo-style transactions,  $\Sigma E$  equals the value of the exposure (the sum of the current market values of all instruments, gold, and cash the [BANK] has lent, sold subject to repurchase, or posted as collateral to the counterparty under the transaction (or netting set)); and

(B) For collateralized OTC derivative contracts and netting sets thereof,  $\Sigma E$  equals the exposure amount of the OTC derivative contract (or netting set) calculated under paragraph (c) or (d) of section 35 of this appendix;

(ii) ΣC equals the value of the collateral (the sum of the current market values of all instruments, gold and cash the [BANK] has borrowed, purchased subject to resale, or taken as collateral from the counterparty under the transaction (or netting set));

(iii) Es equals the absolute value of the net position in a given instrument or in gold (where the net position in a given instrument or in gold equals the sum of the current market values of the instrument or gold the [BANK] has lent, sold subject to repurchase, or posted as collateral to the counterparty minus the sum of the current market values of that same instrument or gold the [BANK]

has borrowed, purchased subject to resale, or taken as collateral from the counterparty);

(iv) Hs equals the market price volatility haircut appropriate to the instrument or gold referenced in Es;

(v) Efx equals the absolute value of the net position of instruments and cash in a currency that is different from the settlement currency (where the net position in a given currency equals the sum of the current market values of any instruments or cash in the currency the [BANK] has lent, sold subject to repurchase, or posted as collateral to the counterparty minus the sum of the current market values of any instruments or

cash in the currency the [BANK] has borrowed, purchased subject to resale, or taken as collateral from the counterparty); and

(vi) Hfx equals the haircut appropriate to the mismatch between the currency referenced in Efx and the settlement currency.

(4) *Standard supervisory haircuts.* Under the standard supervisory haircuts approach:

(i) A [BANK] must use the haircuts for market price volatility (Hs) in Table 9, as adjusted in certain circumstances as provided under in paragraph (c)(4)(iii) and (iv) of this section:

TABLE 9.—STANDARD SUPERVISORY MARKET PRICE VOLATILITY HAIRCUTS <sup>1</sup>

| Applicable external rating grade category for debt securities   | Residual maturity for debt securities | Sovereign entities <sup>2</sup>  | Other issuers |
|---|---------------------------------------|--|---------------|
| Two highest investment-grade rating categories for long-term ratings/<br>highest investment-grade rating category for short-term ratings. | ≤ 1 year .....                        | 0.005  | 0.01          |
|   | > 1 year, ≤ 5 years .....             | 0.02   | 0.04          |
|   | > 5 years .....                       | 0.04   | 0.08          |
| Two lowest investment-grade rating categories for both short- and long-term ratings.  | ≤ 1 year .....                        | 0.01   | 0.02          |
|   | > 1 year, ≤ 5 years .....             | 0.03   | 0.06          |
|   | > 5 years .....                       | 0.06   | 0.12          |
| One rating category below investment grade .....  | All .....                             | 0.15   | 0.25          |
| Main index equities (including convertible bonds) and gold .....  |                                       |  | 0.15          |
| Other publicly traded equities (including convertible bonds), conforming residential mortgages, and non-financial collateral.             |                                       |  | 0.25          |
| Mutual funds .....  |                                       | Highest haircut applicable to any security in which the fund can invest. |               |
| Cash on deposit with the [BANK] (including a certificate of deposit issued by the [BANK]) .....   |                                       |  | 0             |

<sup>1</sup> The market price volatility haircuts in Table 9 are based on a 10-business-day holding period.  
<sup>2</sup> This column includes the haircuts for MDBs and foreign PSEs that receive a zero percent risk weight under section 33 of this appendix.

(ii) For currency mismatches, a [BANK] must use a haircut for foreign exchange rate volatility (Hfx) of 8.0 percent, as adjusted in certain circumstances as provided under paragraph (c)(4)(iii) and (iv) of this section.

(iii) For repo-style transactions, a [BANK] may multiply the standard supervisory haircuts provided in paragraphs (c)(4)(i) and (ii) of this section by the square root of ½ (which equals 0.707107).

(iv) A [BANK] must adjust the standard supervisory haircuts provided in paragraphs (c)(4)(i) and (ii) of this section upward on the basis of a holding period longer than 10 business days (for eligible margin loans and OTC derivative contracts) or five business days (for repo-style transactions) where and as appropriate to take into account the illiquidity of an instrument.

(5) *Own internal estimates for haircuts.* With the prior written approval of the [agency], a [BANK] may calculate haircuts (Hs and Hfx) using its own internal estimates of the volatilities of market prices and foreign exchange rates.

(i) To receive [agency] approval to use its own internal estimates, a [BANK] must satisfy the following minimum quantitative standards:

(A) A [BANK] must use a 99th percentile one-tailed confidence interval.

(B) The minimum holding period for a repo-style transaction is five business days and for an eligible margin loan or OTC derivative contract is 10 business days. When a [BANK] calculates an own-estimates haircut on a T<sub>N</sub>-day holding period, which is different from the minimum holding period for the transaction type, the applicable haircut (H<sub>M</sub>) is calculated using the following square root of time formula:

$$H_M = H_N \sqrt{\frac{T_M}{T_N}}$$

where:

(1) T<sub>M</sub> equals 5 for repo-style transactions and 10 for eligible margin loans and OTC derivative contracts;

(2) T<sub>N</sub> equals the holding period used by the [BANK] to derive H<sub>N</sub>; and

(3) H<sub>N</sub> equals the haircut based on the holding period T<sub>N</sub>.

(C) A [BANK] must adjust holding periods upward where and as appropriate to take into account the illiquidity of an instrument.

(D) The historical observation period must be at least one year.

(E) A [BANK] must update its data sets and recompute haircuts no less frequently than quarterly and must also reassess data sets and

haircuts whenever market prices change materially.

(ii) With respect to debt securities that have an applicable external rating of investment grade, a [BANK] may calculate haircuts for categories of securities. For a category of securities, the [BANK] must calculate the haircut on the basis of internal volatility estimates for securities in that category that are representative of the securities in that category that the [BANK] has lent, sold subject to repurchase, posted as collateral, borrowed, purchased subject to resale, or taken as collateral. In determining relevant categories, the [BANK] must at a minimum take into account:

(A) The type of issuer of the security;

(B) The applicable external rating of the security;

(C) The maturity of the security; and

(D) The interest rate sensitivity of the security.

(iii) With respect to debt securities that have an applicable external rating of below investment grade and equity securities, a [BANK] must calculate a separate haircut for each individual security.

(iv) Where an exposure or collateral (whether in the form of cash or securities) is denominated in a currency that differs from the settlement currency, the [BANK] must

calculate a separate currency mismatch haircut for its net position in each mismatched currency based on estimated volatilities of foreign exchange rates between the mismatched currency and the settlement currency.

(v) A [BANK]'s own estimates of market price and foreign exchange rate volatilities may not take into account the correlations among securities and foreign exchange rates on either the exposure or collateral side of a transaction (or netting set) or the correlations among securities and foreign exchange rates between the exposure and collateral sides of the transaction (or netting set).

(d) *Simple VaR methodology.* (1) With the prior written approval of the [agency], a [BANK] may estimate the exposure amount for a single-product netting set of repo-style transactions or eligible margin loans using a VaR model that meets the requirements in paragraph (d)(3) of this section. However, a [BANK] may not use the VaR model described below to recognize in the exposure amount the benefits of collateral in the form of a conforming residential mortgage (other than for repo-style transactions included in the [BANK]'s VaR-based measure under [the market risk rule]).

(2) The [BANK] must set the exposure amount equal to max

{0, [(ΣE - ΣC) + PFE]},

where:

- (i) ΣE equals the value of the exposure (the sum of the current market values of all instruments, gold, and cash the [BANK] has lent, sold subject to repurchase, or posted as collateral to the counterparty under the netting set);
- (ii) ΣC equals the value of the collateral (the sum of the current market values of all instruments, gold, and cash the [BANK] has borrowed, purchased subject to resale, or taken as collateral from the counterparty under the netting set); and
- (iii) PFE equals the [BANK]'s empirically based best estimate of the 99th percentile, one-tailed confidence interval for an increase in the value of (ΣE - ΣC) over a five-business-day holding period for repo-style transactions or over a 10-business-day holding period for eligible margin loans using a minimum one-year historical observation period of price data representing the instruments that the [BANK] has lent, sold subject to repurchase, posted as collateral, borrowed, purchased subject to resale, or taken as collateral.

(3) The [BANK] must validate its VaR model, including by establishing and maintaining a rigorous and regular backtesting regime. For the purposes of this section, backtesting means a comparison of a [BANK]'s internal estimates with actual outcomes during a sample period not used in model development.

**Section 38. Unsettled Transactions**

(a) *Definitions.* For purposes of this section:

(1) *Delivery-versus-payment (DvP) transaction* means a securities or commodities transaction in which the buyer is obligated to make payment only if the

seller has made delivery of the securities or commodities and the seller is obligated to deliver the securities or commodities only if the buyer has made payment.

(2) *Payment-versus-payment (PvP) transaction* means a foreign exchange transaction in which each counterparty is obligated to make a final transfer of one or more currencies only if the other counterparty has made a final transfer of one or more currencies.

(3) *Qualifying central counterparty* means a counterparty (for example, a clearing house) that:

- (i) Facilitates trades between counterparties in one or more financial markets by either guaranteeing trades or novating contracts;
- (ii) Requires all participants in its arrangements to be fully collateralized on a daily basis; and
- (iii) The [BANK] demonstrates to the satisfaction of the [agency] is in sound financial condition and is subject to effective oversight by a national supervisory authority.

(4) *Normal settlement period.* A transaction has a *normal settlement period* if the contractual settlement period for the transaction is equal to or less than the market standard for the instrument underlying the transaction and equal to or less than five business days.

(5) *Positive current exposure.* The positive current exposure of a [BANK] for a transaction is the difference between the transaction value at the agreed settlement price and the current market price of the transaction, if the difference results in a credit exposure of the [BANK] to the counterparty.

(b) *Scope.* This section applies to all transactions involving securities, foreign exchange instruments, and commodities that have a risk of delayed settlement or delivery. This section does not apply to:

- (1) Transactions accepted by a qualifying central counterparty that are subject to daily marking-to-market and daily receipt and payment of variation margin;
- (2) Repo-style transactions, including unsettled repo-style transactions;
- (3) One-way cash payments on OTC derivative contracts; or
- (4) Transactions with a contractual settlement period that is longer than the normal settlement period (which are treated as OTC derivative contracts as provided in section 35).

(c) *System-wide failures.* In the case of a system-wide failure of a settlement or clearing system, the [agency] may waive risk-based capital requirements for unsettled and failed transactions until the situation is rectified.

(d) *Delivery-versus-payment (DvP) and payment-versus-payment (PvP) transactions.* A [BANK] must hold risk-based capital against any DvP or PvP transaction with a normal settlement period if the [BANK]'s counterparty has not made delivery or payment within five business days after the settlement date. The [BANK] must determine its risk-weighted asset amount for such a transaction by multiplying the positive current exposure of the transaction for the [BANK] by the appropriate risk weight in Table 10.

**TABLE 10.—RISK WEIGHTS FOR UNSETTLED DVP AND PVP TRANSACTIONS**

| Number of business days after contractual settlement date | Risk weight to be applied to positive current exposure (in percent) |
|---|---|
| From 5 to 15 .....  | 100.0   |
| From 16 to 30 .....                                       | 625.0   |
| From 31 to 45 .....                                       | 937.5   |
| 46 or more .....  | 1,250.0   |

(e) *Non-DvP/non-PvP (non-delivery-versus-payment/non-payment-versus-payment) transactions.* (1) A [BANK] must hold risk-based capital against any non-DvP/non-PvP transaction with a normal settlement period if the [BANK] has delivered cash, securities, commodities, or currencies to its counterparty but has not received its corresponding deliverables by the end of the same business day. The [BANK] must continue to hold risk-based capital against the transaction until the [BANK] has received its corresponding deliverables.

(2) From the business day after the [BANK] has made its delivery until five business days after the counterparty delivery is due, the [BANK] must calculate the risk-weighted asset amount for the transaction by treating the current market value of the deliverables owed to the [BANK] as an exposure to the counterparty and using the applicable counterparty risk weight in section 33 of this appendix.

(3) If the [BANK] has not received its deliverables by the fifth business day after counterparty delivery was due, the [BANK] must deduct the current market value of the deliverables owed to the [BANK] 50 percent from tier 1 capital and 50 percent from tier 2 capital.

(f) *Total risk-weighted assets for unsettled transactions.* Total risk-weighted assets for unsettled transactions is the sum of the risk-weighted asset amounts of all DvP, PvP, and non-DvP/non-PvP transactions.

**Part IV. Risk-Weighted Assets for Securitization Exposures**

**Section 41. Operational Requirements for Securitization Exposures**

(a) *Operational criteria for traditional securitizations.* A [BANK] that transfers exposures it has originated or purchased to a securitization SPE or other third party in connection with a traditional securitization may exclude the exposures from the calculation of its risk-weighted assets only if each condition in this paragraph (a) is satisfied. A [BANK] that meets these conditions must hold risk-based capital against any securitization exposures it retains in connection with the securitization. A [BANK] that fails to meet these conditions must instead hold risk-based capital against the transferred exposures as if they had not been securitized and must deduct from tier 1 capital any after-tax gain-on-sale resulting from the transaction. The conditions are:

- (1) The transfer is considered a sale under GAAP;



(2) The [BANK] has transferred to one or more third parties credit risk associated with the underlying exposures; and

(3) Any clean-up calls relating to the securitization are eligible clean-up calls.

(b) *Operational criteria for synthetic securitizations.* For synthetic securitizations, a [BANK] may recognize for risk-based capital purposes the use of a credit risk mitigant to hedge underlying exposures only if each condition in this paragraph (b) is satisfied. A [BANK] that fails to meet these conditions must instead hold risk-based capital against the underlying exposures as if they had not been synthetically securitized. The conditions are:

(1) The credit risk mitigant is financial collateral, an eligible credit derivative, or an eligible guarantee;

(2) The [BANK] transfers credit risk associated with the underlying exposures to one or more third parties, and the terms and conditions in the credit risk mitigants employed do not include provisions that:

(i) Allow for the termination of the credit protection due to deterioration in the credit quality of the underlying exposures;

(ii) Require the [BANK] to alter or replace the underlying exposures to improve the credit quality of the pool of underlying exposures;

(iii) Increase the [BANK]'s cost of credit protection in response to deterioration in the credit quality of the underlying exposures;

(iv) Increase the yield payable to parties other than the [BANK] in response to a deterioration in the credit quality of the underlying exposures; or

(v) Provide for increases in a retained first loss position or credit enhancement provided by the [BANK] after the inception of the securitization;

(3) The [BANK] obtains a well-reasoned opinion from legal counsel that confirms the enforceability of the credit risk mitigant in all relevant jurisdictions; and

(4) Any clean-up calls relating to the securitization are eligible clean-up calls.

#### Section 42. Risk-Weighted Assets for Securitization Exposures

(a) *Hierarchy of approaches.* Except as provided elsewhere in this section or in section 41:

(1) A [BANK] must deduct from tier 1 capital any after-tax gain-on-sale resulting from a securitization and must deduct from total capital in accordance with paragraph (c) of this section the portion of any CEIO that does not constitute after-tax gain-on-sale.

(2) If a securitization exposure does not require deduction under paragraph (a)(1) of this section and qualifies for the Ratings-Based Approach (RBA) in section 43 of this appendix, a [BANK] must apply the RBA to the exposure.

(3) If a securitization exposure does not require deduction under paragraph (a)(1) of this section and does not qualify for the RBA, a [BANK] must apply the treatments in section 44.

(4) If a securitization exposure is an OTC derivative contract (other than a credit derivative) that has a first priority claim on the cash flows from the underlying exposures (notwithstanding amounts due under interest

rate or currency derivative contracts, fees due, or other similar payments), with approval of the [agency], a [BANK] may choose to set the risk-weighted asset amount of the exposure equal to the amount of the exposure as determined in paragraph (d) of this section rather than apply the hierarchy of approaches described in paragraphs (a)(1) through (3) of this section.

(b) *Total risk-weighted assets for securitization exposures.* A [BANK]'s total risk-weighted assets for securitization exposures equals the sum of the risk-weighted asset amount for securitization exposures that the [BANK] risk weights under section 43, 44, or 45 of this appendix plus any risk-weighted asset amount calculated under section 46 of this appendix, as modified by paragraphs (e) through (k) of this section.

(c) *Deductions.* (1) If a [BANK] must deduct a securitization exposure from total capital, the [BANK] must take the deduction 50 percent from tier 1 capital and 50 percent from tier 2 capital. If the amount deductible from tier 2 capital exceeds the [BANK]'s tier 2 capital, the [BANK] must deduct the excess from tier 1 capital.

(2) A [BANK] may calculate any deduction from tier 1 capital and tier 2 capital for a securitization exposure net of any deferred tax liabilities associated with the securitization exposure.

(d) *Exposure amount of a securitization exposure.* (1) *On-balance sheet securitization exposures.* The exposure amount of an on-balance sheet securitization exposure that is not a repo-style transaction, eligible margin loan, or OTC derivative contract (other than a credit derivative) is:

(i) The [BANK]'s carrying value minus any unrealized gains and plus any unrealized losses on the exposure, if the exposure is a security classified as available-for-sale; or

(ii) The [BANK]'s carrying value, if the exposure is not a security classified as available-for-sale.

(2) *Off-balance sheet securitization exposures.* (i) The exposure amount of an off-balance sheet securitization exposure that is not a repo-style transaction or an OTC derivative contract (other than a credit derivative) is the notional amount of the exposure. For an off-balance sheet securitization exposure to an ABCP program, such as a liquidity facility, the notional amount may be reduced to the maximum potential amount that the [BANK] could be required to fund given the ABCP program's current underlying assets (calculated without regard to the current credit quality of those assets).

(ii) A [BANK] must determine the exposure amount of an eligible ABCP liquidity facility by multiplying the notional amount of the exposure by the appropriate CCF:

(A) 20 percent, for an eligible ABCP liquidity facility with an original maturity of one year or less that does not qualify for the RBA.

(B) 50 percent, for an eligible ABCP liquidity facility with an original maturity of over one year that does not qualify for the RBA.

(C) 100 percent, for an eligible ABCP liquidity facility that qualifies for the RBA.

(3) *Repo-style transactions, eligible margin loans, and OTC derivative contracts.* The exposure amount of a securitization exposure that is a repo-style transaction, eligible margin loan, or OTC derivative contract (other than a credit derivative) is the exposure amount of the transaction as calculated under section 35 or 37 of this appendix.

(e) *Overlapping exposures.* If a [BANK] has multiple securitization exposures that provide duplicative coverage to the underlying exposures of a securitization (such as when a [BANK] provides a program-wide credit enhancement and multiple pool-specific liquidity facilities to an ABCP program), the [BANK] is not required to hold duplicative risk-based capital against the overlapping position. Instead, the [BANK] may apply to the overlapping position the applicable risk-based capital treatment that results in the highest risk-based capital requirement.

(f) *Implicit support.* If a [BANK] provides support to a securitization in excess of the [BANK]'s contractual obligation to provide credit support to the securitization (implicit support):

(1) The [BANK] must hold regulatory capital against all of the underlying exposures associated with the securitization as if the exposures had not been securitized and must deduct from tier 1 capital any after-tax gain-on-sale resulting from the securitization; and

(2) The [BANK] must disclose publicly:

(i) That it has provided implicit support to the securitization; and

(ii) The regulatory capital impact to the [BANK] of providing such implicit support.

(g) *Undrawn portion of an eligible servicer cash advance facility.* Regardless of any other provision of this part, a [BANK] is not required to hold risk-based capital against the undrawn portion of an eligible servicer cash advance facility.

(h) *Interest-only mortgage-backed securities.* Regardless of any other provisions of this part, the risk weight for a non-credit-enhancing interest-only mortgage-backed security may not be less than 100 percent.

(i) *Small-business loans and leases on personal property transferred with recourse.* (1) Regardless of any other provisions of this appendix, a [BANK] that has transferred small-business loans and leases on personal property (small-business obligations) with recourse must include in risk-weighted assets only the contractual amount of retained recourse if all the following conditions are met:

(i) The transaction is a sale under GAAP.

(ii) The [BANK] establishes and maintains, pursuant to GAAP, a non-capital reserve sufficient to meet the [BANK]'s reasonably estimated liability under the recourse arrangement.

(iii) The loans and leases are to businesses that meet the criteria for a small-business concern established by the Small Business Administration under section 3(a) of the Small Business Act (15 U.S.C. 632).

(iv) The [BANK] is well capitalized, as defined in the [agency]'s prompt corrective action regulation—12 CFR part 6 (for national banks); 12 CFR part 208, subpart D (for state

member banks or bank holding companies); 12 CFR part 325, subpart B (for state nonmember banks); and 12 CFR part 565 (for savings associations). For purposes of determining whether a [BANK] is well capitalized for purposes of this paragraph, the [BANK]'s capital ratios must be calculated without regard to the capital treatment for transfers of small-business obligations with recourse specified in this paragraph (i)(1).

(2) The total outstanding amount of recourse retained by a [BANK] on transfers of small-business obligations receiving the capital treatment specified in paragraph (i)(1) of this section cannot exceed 15 percent of the [BANK]'s total qualifying capital.

(3) If a [BANK] ceases to be well capitalized or exceeds the 15 percent capital limitation, the capital treatment specified in paragraph (i)(1) of this section will continue to apply to any transfers of small-business obligations with recourse that occurred during the time that the [BANK] was well capitalized and did not exceed the capital limit.

(4) The risk-based capital ratios of the [BANK] must be calculated without regard to the capital treatment for transfers of small-business obligations with recourse specified in paragraph (i)(1) of this section as provided in 12 CFR part 3, appendix A (for national banks); 12 CFR part 208, appendix A (for state member banks); 12 CFR part 225, appendix A (for bank holding companies); 12 CFR part 325, appendix A (for state nonmember banks); and 12 CFR 567.6(b)(5)(v) (for savings associations).

(j) *Consolidated ABCP programs.* (1) A [BANK] that qualifies as a primary beneficiary and must consolidate an ABCP program as a variable interest entity under GAAP may exclude the consolidated ABCP program assets from risk-weighted assets if the [BANK] is the sponsor of the ABCP program. If a [BANK] excludes such consolidated ABCP program assets from risk-weighted assets, the [BANK] must hold risk-based capital against any securitization exposures of the [BANK] to the ABCP program in accordance with this part.

(2) If a [BANK] either is not permitted, or elects not, to exclude consolidated ABCP program assets from its risk-weighted assets, the [BANK] must hold risk-based capital against the consolidated ABCP program

assets in accordance with this appendix but is not required to hold risk-based capital against any securitization exposures of the [BANK] to the ABCP program.

(k) *Nth-to-default credit derivatives.* (1) *First-to-default credit derivatives.* (i) *Protection purchaser.* A [BANK] that obtains credit protection on a group of underlying exposures through a first-to-default credit derivative must determine its risk-based capital requirement for the underlying exposures as if the [BANK] synthetically securitized the underlying exposure with the lowest risk-based capital requirement and had obtained no credit risk mitigant on the other underlying exposures.

(ii) *Protection provider.* A [BANK] that provides credit protection on a group of underlying exposures through a first-to-default credit derivative must determine its risk-weighted asset amount for the derivative by applying the RBA or, if the derivative does not qualify for the RBA, by setting its risk-weighted asset amount for the derivative equal to the product of:

- (A) The protection amount of the derivative; and
- (B) The sum of the risk weights of the individual underlying exposures, up to a maximum of 1,250 percent.

(2) *Second-or-subsequent-to-default credit derivatives.* (i) *Protection purchaser.* (A) A [BANK] that obtains credit protection on a group of underlying exposures through an nth-to-default credit derivative (other than a first-to-default credit derivative) may recognize the credit risk mitigation benefits of the derivative only if:

- (1) The [BANK] also has obtained credit protection on the same underlying exposures in the form of first-through-(n-1)-to-default credit derivatives; or
- (2) If n-1 of the underlying exposures have already defaulted.

(B) If a [BANK] satisfies the requirements of paragraph (k)(2)(i)(A) of this section, the [BANK] must determine its risk-based capital requirement for the underlying exposures as if the [BANK] had only synthetically securitized the underlying exposure with the nth lowest risk-based capital requirement and had obtained no credit risk mitigant on the other underlying exposures.

(ii) *Protection provider.* A [BANK] that provides credit protection on a group of underlying exposures through an nth-to-

default credit derivative (other than a first-to-default credit derivative) must determine its risk-weighted asset amount for the derivative by applying the RBA in section 43 of this appendix (if the derivative qualifies for the RBA) or, if the derivative does not qualify for the RBA, by setting its risk-weighted asset amount for the derivative equal to the product of:

- (A) The protection amount of the derivative; and
- (B) The sum of the risk weights of the individual underlying exposures (excluding the n-1 underlying exposures with the lowest risk-based capital requirement), up to a maximum of 1,250 percent.

*Section 43. Ratings-Based Approach (RBA)*

(a) *Eligibility requirements for use of the RBA.* (1) *Originating [BANK].* An originating [BANK] must use the RBA to calculate its risk-based capital requirement for a securitization exposure if the exposure has two or more external or inferred ratings (and may not use the RBA if the exposure has fewer than two external or inferred ratings).

(2) *Investing [BANK].* An investing [BANK] must use the RBA to calculate the risk-based capital requirement for a securitization exposure if the exposure has one or more external or inferred ratings (and may not use the RBA if the exposure has no external rating or inferred rating).

(b) *Ratings-based approach.* (1) A [BANK] must determine its risk-based capital requirement for a securitization exposure not required to be deducted under Table 11 or 12 by multiplying the exposure amount (as determined in paragraph (d) of section 42) by the risk weight that corresponds to the applicable external or applicable inferred rating provided in Table 11 or 12. If the applicable table requires deduction, the exposure amount must be deducted from total capital in accordance with paragraph (c) of section 42 of this appendix.

(2) A [BANK] must apply the risk weights in Table 11 when the securitization exposure's applicable external or applicable inferred rating represents a long-term credit rating, and must apply the risk weights in Table 12 when the securitization exposure's applicable external or applicable inferred rating represents a short-term credit rating.

TABLE 11.—LONG-TERM CREDIT RATING RISK WEIGHTS UNDER THE RBA

| Applicable external or applicable inferred rating of a securitization exposure | Example   | Risk weight (in percent) |
|--|-----------|--------------------------|
| Highest investment grade rating .....  | AAA ..... | 20.                      |
| Second-highest investment grade rating .....                                   | AA .....  | 20.                      |
| Third-highest investment grade rating .....                                    | A .....   | 50.                      |
| Lowest investment grade rating .....   | BBB ..... | 100.                     |
| One category below investment grade .....                                      | BB .....  | 350.                     |
| Two categories below investment grade .....                                    | B .....   | Deduction.               |
| Three categories or more below investment grade .....                          | CCC ..... | Deduction.               |

TABLE 12.—SHORT-TERM CREDIT RATING RISK WEIGHTS UNDER THE RBA

| Applicable external or applicable inferred rating of a securitization exposure | Example       | Risk Weight (in percent) |
|--|---------------|--------------------------|
| Highest investment grade rating .....  | A-1/P-1 ..... | 20.                      |
| Second-highest investment grade rating .....                                   | A-2/P-2 ..... | 50.                      |
| Third-highest investment grade rating .....                                    | A-3/P-3 ..... | 100.                     |
| All other ratings .....  | N/A .....     | Deduction.               |

**Section 44. Securitization Exposures That Do Not Qualify for the RBA**

A [BANK] must deduct from total capital all securitization exposures that do not qualify for the RBA in section 43 of this appendix with the following exceptions, provided that the [BANK] knows the composition of the underlying exposures at all times:

(a) *An eligible ABCP liquidity facility.* A [BANK] may determine the risk-weighted asset amount of an eligible ABCP liquidity facility by multiplying the exposure amount by the highest risk weight applicable to any of the individual underlying exposures covered by the facility.

(b) *A first priority securitization exposure.* A [BANK] may determine the risk-weighted asset amount of a first priority securitization exposure by multiplying the exposure amount by the weighted-average risk weight of the underlying exposures. For purposes of this section, a first priority securitization exposure is a securitization exposure that has a first priority claim on the cash flows from the underlying exposures and that is not an eligible ABCP liquidity facility. When determining whether a securitization exposure has a first priority claim on the cash flows from the underlying exposures, a [BANK] is not required to consider amounts due under interest rate or currency derivative contracts, fees due, or other similar payments.

(c) *A securitization exposure in a second loss position or better in an ABCP program.*

(1) A [BANK] may determine the risk-weighted asset amount of a securitization exposure that is in a second loss position or better in an ABCP program that meets the requirements of paragraph (c)(2) of this section by multiplying the exposure amount by the higher of the following risk weights:

- (i) 100 percent; or
- (ii) The highest risk weight applicable to any of the individual underlying exposures of the ABCP program.

(2) *Requirements.* (i) The exposure is not a first priority securitization exposure or an eligible ABCP liquidity facility;

(ii) The exposure must be economically in a second loss position or better, and the first loss position must provide significant credit protection to the second loss position;

(iii) The credit risk of the exposure must be the equivalent of investment grade or better; and

(iv) The [BANK] holding the exposure must not retain or provide the first loss position.

**Section 45. Recognition of Credit Risk Mitigants for Securitization Exposures**

(a) *General.* (1) An originating [BANK] that has obtained a credit risk mitigant to hedge

its securitization exposure to a synthetic or traditional securitization that satisfies the operational criteria in section 41 of this appendix may recognize the credit risk mitigant under section 36 or 37 of this appendix, but only as provided in this section.

(2) An investing [BANK] that has obtained a credit risk mitigant to hedge a securitization exposure may recognize the credit risk mitigant under section 36 or 37 of this appendix, but only as provided in this section.

(3) A [BANK] that has used section 43 or section 44 to calculate its risk-based capital requirement for a securitization exposure based on external or inferred ratings that reflect the benefits of a credit risk mitigant provided to the associated securitization or that supports some or all of the underlying exposures may not use the credit risk mitigation rules in this section to further reduce its risk-based capital requirement for the exposure to reflect that credit risk mitigant.

(b) *Eligible guarantors for securitization exposures.* A [BANK] may only recognize an eligible guarantee or eligible credit derivative from an eligible guarantor that:

- (1) Is described in paragraph (1) of the definition of eligible guarantor; or
- (2) Has issued and outstanding an unsecured debt security without credit enhancement that has an applicable external rating based on a long-term rating in one of the three highest investment grade rating categories.

(c) *Mismatches.* A [BANK] must make applicable adjustments to the protection amount of an eligible guarantee or credit derivative as required in paragraphs (d), (e), and (f) of section 36 of this appendix for any hedged securitization exposure. In the context of a synthetic securitization, when an eligible guarantee or eligible credit derivative covers multiple hedged exposures that have different residual maturities, the [BANK] must use the longest residual maturity of any of the hedged exposures as the residual maturity of all the hedged exposures.

**Section 46. Risk-Weighted Assets for Securitizations with Early Amortization Provisions**

(a) *General.* (1) An originating [BANK] must hold risk-based capital against the sum of the originating [BANK]'s interest and the investors' interest in a securitization that:

- (i) Includes one or more underlying exposures in which the borrower is permitted to vary the drawn amount within an agreed limit under a line of credit; and
- (ii) Contains an early amortization provision.

(2) The total capital requirement for a [BANK]'s exposures to a single securitization with an early amortization provision is subject to a maximum capital requirement equal to the greater of:

- (i) The capital requirement for retained securitization exposures, or
- (ii) The capital requirement for the underlying exposures that would apply if the [BANK] directly held the underlying exposures.

(3) For securitizations described in paragraph (a)(1) of this section, an originating [BANK] must calculate the risk-based capital requirement for the originating [BANK]'s interest under sections 42 through 45 of this appendix, and the risk-weighted asset amount for the investors' interest under paragraph (c) of this section.

(b) *Definitions.* For purposes of this section:

(1) *Investors' interest* means, with respect to a securitization, the exposure amount of the underlying exposures multiplied by the ratio of:

(i) The total amount of securitization exposures issued by the securitization SPE; divided by

(ii) The outstanding principal amount of the underlying exposures.

(2) *Excess spread* for a period means:

(i) Gross finance charge collections and other income received by a securitization SPE (including market interchange fees) over a period minus interest paid to the holders of the securitization exposures, servicing fees, charge-offs, and other senior trust or similar expenses of the SPE over the period; divided by

(ii) The principal balance of the underlying exposures at the end of the period.

(c) *Risk-weighted asset amount for investors' interest.* The originating [BANK]'s risk-weighted asset amount for the investors' interest in the securitization is equal to the product of the following four quantities:

- (1) The investors' interest;
- (2) The appropriate conversion factor in paragraph (d) of this section;
- (3) The weighted-average risk weight that would apply under this appendix to the underlying exposures if the underlying exposures had not been securitized; and
- (4) The proportion of the underlying exposures in which the borrower is permitted to vary the drawn amount within an agreed limit under a line of credit.

(d) *Conversion factors.* (1)(i) Except as provided in paragraph (d)(2) of this section, to calculate the appropriate conversion factor, a [BANK] must use Table 13 for a securitization that contains a controlled early amortization provision and must use Table 14 for a securitization that contains a non-controlled early amortization provision. In

circumstances where a securitization contains a mix of retail and nonretail exposures or a mix of committed and uncommitted exposures, a [BANK] may take a pro rata approach to determining the conversion factor for the securitization's early amortization provision. If a pro rata approach is not feasible, a [BANK] must treat the mixed securitization as a securitization of

nonretail exposures if a single underlying exposure is a nonretail exposure and must treat the mixed securitization as a securitization of committed exposures if a single underlying exposure is a committed exposure.  
 (ii) To find the appropriate conversion factor in the tables, a [BANK] must divide the three-month average annualized excess

spread of the securitization by the excess spread trapping point in the securitization structure. In securitizations that do not require excess spread to be trapped, or that specify trapping points based primarily on performance measures other than the three-month average annualized excess spread, the excess spread trapping point is 4.5 percent.

TABLE 13.—CONTROLLED EARLY AMORTIZATION PROVISIONS

| 3-month average annualized excess spread                 | Uncommitted CF (in percent) | Committed CF (in percent) |
|--|-----------------------------|---------------------------|
| Retail Credit Lines:                                     |                             |                           |
| Greater than or equal to 133.33% of trapping point ..... | 0                           | 90                        |
| Less than 133.33% to 100% of trapping point .....        | 1                           | .....                     |
| Less than 100% to 75% of trapping point .....            | 2                           | .....                     |
| Less than 75% to 50% of trapping point .....             | 10                          | .....                     |
| Less than 50% to 25% of trapping point .....             | 20                          | .....                     |
| Less than 25% of trapping point .....                    | 40                          | .....                     |
| Non-retail credit lines .....                            | 90                          | 90                        |

TABLE 14.—NON-CONTROLLED EARLY AMORTIZATION PROVISIONS

| 3-month average annualized excess spread                 | Uncommitted CF (in percent) | Committed CF (in percent) |
|--|-----------------------------|---------------------------|
| Retail Credit Lines:                                     |                             |                           |
| Greater than or equal to 133.33% of trapping point ..... | 0                           | 100                       |
| Less than 133.33% to 100% of trapping point .....        | 5                           | .....                     |
| Less than 100% to 75% of trapping point .....            | 15                          | .....                     |
| Less than 75% to 50% of trapping point .....             | 50                          | .....                     |
| Less than 50% of trapping point .....                    | 100                         | .....                     |
| Non-retail credit lines .....                            | 100                         | 100                       |

(2) For a securitization for which all or substantially all of the underlying exposures are secured by liens on one-to-four family residential property, a [BANK] may calculate the appropriate conversion factor discussed in paragraph (c)(2) of this section using paragraph (d)(1) of this section or may use a conversion factor of 10 percent. If the [BANK] chooses to use a conversion factor of 10 percent, it must use that conversion factor for all securitizations for which all or substantially all of the underlying exposures are secured by liens on one-to-four family residential property.

**Part V. Risk-Weighted Assets for Equity Exposures**

*Section 51. Introduction and Exposure Measurement*

(a) *General.* To calculate its risk-weighted asset amounts for equity exposures that are not equity exposures to investment funds, a [BANK] must use the Simple Risk-Weight Approach (SRWA) in section 52. A [BANK] must use the look-through approaches in section 53 to calculate its risk-weighted asset amounts for equity exposures to investment funds.

(b) *Adjusted carrying value.* For purposes of this part, the adjusted carrying value of an equity exposure is:

(1) For the on-balance sheet component of an equity exposure, the [BANK]'s carrying value of the exposure reduced by any unrealized gains on the exposure that are

reflected in such carrying value but excluded from the [BANK]'s tier 1 and tier 2 capital; and

(2) For the off-balance sheet component of an equity exposure that is not an equity commitment, the effective notional principal amount of the exposure, the size of which is equivalent to a hypothetical on-balance sheet position in the underlying equity instrument that would evidence the same change in fair value (measured in dollars) for a given small change in the price of the underlying equity instrument, minus the adjusted carrying value of the on-balance sheet component of the exposure as calculated in paragraph (b)(1) of this section.

(3) For a commitment to acquire an equity exposure (an equity commitment), the effective notional principal amount of the exposure multiplied by the following conversion factors (CFs):

(i) Conditional equity commitments with an original maturity of one year or less receive a CF of 20 percent.

(ii) Conditional equity commitments with an original maturity of over one year receive a CF of 50 percent.

(iii) Unconditional equity commitments receive a CF of 100 percent.

*Section 52. Simple Risk-Weight Approach (SRWA)*

(a) *General.* Under the SRWA, a [BANK]'s total risk-weighted assets for equity exposures equals the sum of the risk-

weighted asset amounts for each of the [BANK]'s individual equity exposures (other than equity exposures to an investment fund) as determined in this section and the risk-weighted asset amounts for each of the [BANK]'s individual equity exposures to an investment fund as determined in section 53.

(b) *SRWA computation for individual equity exposures.* A [BANK] must determine the risk-weighted asset amount for an individual equity exposure (other than an equity exposure to an investment fund) by multiplying the adjusted carrying value of the equity exposure or the effective portion and ineffective portion of a hedge pair (as defined in paragraph (c) of this section) by the lowest applicable risk weight in this paragraph (b).

(1) *Zero percent risk weight equity exposures.* An equity exposure to a sovereign entity, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, an MDB, a PSE, and any other entity whose credit exposures receive a zero percent risk weight under section 33 may be assigned a zero percent risk weight.

(2) *20 percent risk weight equity exposures.* An equity exposure to a Federal Home Loan Bank or Federal Agricultural Mortgage Corporation (Farmer Mac) is assigned a 20 percent risk weight.

(3) *100 percent risk weight equity exposures.* The following equity exposures are assigned a 100 percent risk weight:

(i) *Community development equity exposures.* (A) For banks and bank holding companies, an equity exposure that qualifies as a community development investment under 12 U.S.C. 24 (Eleventh), excluding equity exposures to an unconsolidated small business investment company and equity exposures held through a consolidated small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682).

(B) For savings associations, an equity exposure that is designed primarily to promote community welfare, including the welfare of low- and moderate-income communities or families, such as by providing services or employment, and excluding equity exposures to an unconsolidated small business investment company and equity exposures held through a small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682).

(ii) *Effective portion of hedge pairs.* The effective portion of a hedge pair.

(iii) *Non-significant equity exposures.* Equity exposures, excluding exposures to an investment firm that would meet the definition of a traditional securitization were it not for the [agency]'s application of paragraph (8) of that definition and has greater than immaterial leverage, to the extent that the aggregate adjusted carrying value of the exposures does not exceed 10 percent of the [BANK]'s tier 1 capital plus tier 2 capital.

(A) To compute the aggregate adjusted carrying value of a [BANK]'s equity exposures for purposes of this paragraph (b)(3)(iii), the [BANK] may exclude equity exposures described in paragraphs (b)(1), (b)(2), (b)(3)(i), and (b)(3)(ii) of this section, the equity exposure in a hedge pair with the smaller adjusted carrying value, and a proportion of each equity exposure to an investment fund equal to the proportion of the assets of the investment fund that are not equity exposures or that meet the criterion of paragraph (b)(3)(i) of this section. If a [BANK] does not know the actual holdings of the investment fund, the [BANK] may calculate the proportion of the assets of the fund that are not equity exposures based on the terms of the prospectus, partnership agreement, or similar contract that defines the fund's permissible investments. If the sum of the investment limits for all exposure classes within the fund exceeds 100 percent, the [BANK] must assume for purposes of this paragraph (b)(3)(iii) that the investment fund invests to the maximum extent possible in equity exposures.

(B) When determining which of a [BANK]'s equity exposures qualify for a 100 percent risk weight under this paragraph, a [BANK] first must include equity exposures to unconsolidated small business investment companies or held through consolidated small business investment companies described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682), then must include publicly traded equity exposures (including those held indirectly through investment funds), and then must include non-publicly traded equity

exposures (including those held indirectly through investment funds).

(4) *300 percent risk weight equity exposures.* A publicly traded equity exposure (other than an equity exposure described in paragraph (b)(6) of this section and including the ineffective portion of a hedge pair) is assigned a 300 percent risk weight.

(5) *400 percent risk weight equity exposures.* An equity exposure (other than an equity exposure described in paragraph (b)(6) of this section) that is not publicly traded is assigned a 400 percent risk weight.

(6) *600 percent risk weight equity exposures.* An equity exposure to an investment firm that:

(i) Would meet the definition of a traditional securitization were it not for the [agency]'s application of paragraph (8) of that definition, and

(ii) Has greater than immaterial leverage is assigned a 600 percent risk weight.

(c) *Hedge transactions.* (1) *Hedge pair.* A hedge pair is two equity exposures that form an effective hedge so long as each equity exposure is publicly traded or has a return that is primarily based on a publicly traded equity exposure.

(2) *Effective hedge.* Two equity exposures form an effective hedge if the exposures either have the same remaining maturity or each has a remaining maturity of at least three months; the hedge relationship is formally documented in a prospective manner (that is, before the [BANK] acquires at least one of the equity exposures); the documentation specifies the measure of effectiveness (E) the [BANK] will use for the hedge relationship throughout the life of the transaction; and the hedge relationship has an E greater than or equal to 0.8. A [BANK] must measure E at least quarterly and must use one of three alternative measures of E:

(i) Under the dollar-offset method of measuring effectiveness, the [BANK] must determine the ratio of value change (RVC). The RVC is the ratio of the cumulative sum of the periodic changes in value of one equity exposure to the cumulative sum of the periodic changes in the value of the other equity exposure. If RVC is positive, the hedge is not effective and E equals 0. If RVC is negative and greater than or equal to  $-1$  (that is, between zero and  $-1$ ), then E equals the absolute value of RVC. If RVC is negative and less than  $-1$ , then E equals 2 plus RVC.

(ii) Under the variability-reduction method of measuring effectiveness:

$$E = 1 - \frac{\sum_{t=1}^T (X_t - X_{t-1})^2}{\sum_{t=1}^T (A_t - A_{t-1})^2},$$

where:

(A)  $X_t = A_t - B_t$ ;

(B)  $A_t$  = the value at time t of one exposure in a hedge pair; and

(C)  $B_t$  = the value at time t of the other exposure in a hedge pair.

(iii) Under the regression method of measuring effectiveness, E equals the coefficient of determination of a regression in which the change in value of one exposure

in a hedge pair is the dependent variable and the change in value of the other exposure in a hedge pair is the independent variable. However, if the estimated regression coefficient is positive, then the value of E is zero.

(3) The effective portion of a hedge pair is E multiplied by the greater of the adjusted carrying values of the equity exposures forming a hedge pair.

(4) The ineffective portion of a hedge pair is  $(1 - E)$  multiplied by the greater of the adjusted carrying values of the equity exposures forming a hedge pair.

#### Section 53. Equity Exposures to Investment Funds

(a) *Available approaches.* (1) Unless the exposure meets the requirements for a community development equity exposure in paragraph (b)(3)(i) of section 52, a [BANK] must determine the risk-weighted asset amount of an equity exposure to an investment fund under the Full Look-Through Approach in paragraph (b) of this section, the Simple Modified Look-Through Approach in paragraph (c) of this section, the Alternative Modified Look-Through Approach in paragraph (d) of this section, or, if the investment fund qualifies for the Money Market Fund Approach, the Money Market Fund Approach in paragraph (e) of this section.

(2) The risk-weighted asset amount of an equity exposure to an investment fund that meets the requirements for a community development equity exposure in paragraph (b)(3)(i) of section 52 is its adjusted carrying value.

(3) If an equity exposure to an investment fund is part of a hedge pair and the [BANK] does not use the Full Look-Through Approach, the [BANK] may use the ineffective portion of the hedge pair as determined under paragraph (c) of section 52 as the adjusted carrying value for the equity exposure to the investment fund. The risk-weighted asset amount of the effective portion of the hedge pair is equal to its adjusted carrying value.

(b) *Full Look-Through Approach.* A [BANK] that is able to calculate a risk-weighted asset amount for its proportional ownership share of each exposure held by the investment fund (as calculated under this appendix as if the proportional ownership share of each exposure were held directly by the [BANK]) may set the risk-weighted asset amount of the [BANK]'s exposure to the fund equal to the product of:

(1) The aggregate risk-weighted asset amounts of the exposures held by the fund as if they were held directly by the [BANK]; and

(2) The [BANK]'s proportional ownership share of the fund.

(c) *Simple Modified Look-Through Approach.* Under this approach, the risk-weighted asset amount for a [BANK]'s equity exposure to an investment fund equals the adjusted carrying value of the equity exposure multiplied by the highest risk weight that applies to any exposure the fund is permitted to hold under its prospectus, partnership agreement, or similar contract that defines the fund's permissible

investments (excluding derivative contracts that are used for hedging rather than speculative purposes and that do not constitute a material portion of the fund's exposures).

(d) *Alternative Modified Look-Through Approach.* Under this approach, a [BANK] may assign the adjusted carrying value of an equity exposure to an investment fund on a pro rata basis to different risk weight categories under this appendix based on the investment limits in the fund's prospectus, partnership agreement, or similar contract that defines the fund's permissible investments. The risk-weighted asset amount for the [BANK]'s equity exposure to the investment fund equals the sum of each portion of the adjusted carrying value assigned to an exposure class multiplied by the applicable risk weight under this appendix. If the sum of the investment limits for exposure classes within the fund exceeds 100 percent, the [BANK] must assume that the fund invests to the maximum extent permitted under its investment limits in the exposure class with the highest applicable risk weight under this appendix and continues to make investments in order of the exposure class with the next highest applicable risk weight under this appendix until the maximum total investment level is reached. If more than one exposure class applies to an exposure, the [BANK] must use the highest applicable risk weight. A [BANK] may exclude derivative contracts held by the fund that are used for hedging rather than for speculative purposes and do not constitute a material portion of the fund's exposures.

(e) *Money Market Fund Approach.* The risk-weighted asset amount for a [BANK]'s equity exposure to an investment fund that is a money market fund subject to 17 CFR 270.2a-7 and that has an applicable external rating in the highest investment-grade rating category equals the adjusted carrying value of the equity exposure multiplied by seven percent.

**Part VI. Risk-Weighted Assets for Operational Risk**

*Section 61. Basic Indicator Approach*

(a) *Risk-weighted assets for operational risk.* Risk-weighted assets for operational risk equals 15 percent of a [BANK]'s average

positive annual gross income multiplied by 12.5.

(b) *Average positive annual gross income.*

A [BANK]'s average positive annual gross income equals the sum of the [BANK]'s positive annual gross income, as described below, over the three most recent calendar years divided by the number of those years in which its annual gross income is positive. A [BANK] must exclude from this calculation amounts from any year in which the annual gross income is negative or zero.

(c) *Annual gross income equals:*

(1) For a [BANK], its net interest income plus its total noninterest income minus its underwriting income from insurance and reinsurance activities as reported on the [BANK]'s Call Report.

(2) For a bank holding company, its net interest income plus its total noninterest income minus its underwriting income from insurance and reinsurance activities as reported on the bank holding company's Y9-C Report.

(3) For a savings association, its net interest income (expense) before provision for losses on interest-bearing assets, plus total noninterest income, minus the portion of its other fees and charges that represents income derived from insurance and reinsurance underwriting activities, minus (plus) its income (loss) from the sale of assets held for sale and available-for-sale securities to include only the profit or loss from the disposition of available-for-sale securities pursuant to FASB Statement No. 115, minus (plus) its income (loss) from the sale of securities held-to-maturity, all as reported on the savings association's year-end Thrift Financial Report.

**Part VII. Disclosure**

*Section 71. Disclosure Requirements*

(a) Each [BANK] must publicly disclose each quarter its total and tier 1 risk-based capital ratios and their components (that is, tier 1 capital, tier 2 capital, total qualifying capital, and total risk-weighted assets).<sup>74</sup>

(b) A [BANK] must comply with paragraph (c) of this section unless it is a consolidated subsidiary of a bank holding company or depository institution that is subject to these disclosure requirements.

(c) (1) Each [BANK] that is not a subsidiary of a non-U.S. banking organization that is subject to comparable public disclosure requirements in its home jurisdiction must provide timely public disclosures each calendar quarter of the information in tables 15.1-15.10 below. If a significant change occurs, such that the most recent reported amounts are no longer reflective of the [BANK]'s capital adequacy and risk profile, then a brief discussion of this change and its likely impact must be provided as soon as practicable thereafter. Qualitative disclosures that typically do not change each quarter (for example, a general summary of the [BANK]'s risk management objectives and policies, reporting system, and definitions) may be disclosed annually, provided any significant changes to these are disclosed in the interim. Management is encouraged to provide all of the disclosures required by this appendix in one place on the [BANK]'s public Web site.<sup>75</sup> The [BANK] must make these disclosures publicly available for each of the last three years (that is, twelve quarters) or such shorter period [beginning on the effective date of a [BANK]'s election to use this appendix].

(2) Each [BANK] is required to have a formal disclosure policy approved by the board of directors that addresses its approach for determining the disclosures it makes. The policy must address the associated internal controls and disclosure controls and procedures. The board of directors and senior management are responsible for establishing and maintaining an effective internal control structure over financial reporting, including the disclosures required by this appendix, and must ensure that appropriate review of the disclosures takes place. One or more senior officers of the [BANK] must attest that the disclosures meet the requirements of this appendix.

(3) If a [BANK] believes that disclosure of specific commercial or financial information would prejudice seriously its position by making public information that is either proprietary or confidential in nature, the [BANK] need not disclose those specific items, but must disclose more general information about the subject matter of the requirement, together with the fact that, and the reason why, the specific items of information have not been disclosed.

TABLE 15.1.—SCOPE OF APPLICATION

|                                |   |
|--------------------------------|---|
| Qualitative Disclosures .....  | (a) The name of the top corporate entity in the group to which the appendix applies.<br>(b) An outline of differences in the basis of consolidation for accounting and regulatory purposes, with a brief description of the entities <sup>1</sup> within the group:<br>(1) that are fully consolidated;<br>(2) that are deconsolidated and deducted;<br>(3) for which the regulatory capital requirement is deducted; and<br>(4) that are neither consolidated nor deducted (for example, where the investment is risk weighted). |
| Quantitative Disclosures ..... | (c) Any restrictions, or other major impediments, on transfer of funds or regulatory capital within the group.<br>(d) The aggregate amount of surplus capital of insurance subsidiaries included in the regulatory capital of the consolidated group.   |

<sup>74</sup> Other public disclosure requirements continue to apply—for example, Federal securities law and regulatory reporting requirements.

<sup>75</sup> Alternatively, a [BANK] may provide the disclosures in more than one place, as some of them may be included in public financial reports (for example, in Management's Discussion and Analysis included in SEC filings) or other regulatory reports.

The [BANK] must publicly provide a summary table that specifically indicates where all the disclosures may be found (for example, regulatory report schedules, page numbers in annual reports).

TABLE 15.1.—SCOPE OF APPLICATION—Continued

|  |  |
|--|--|
|  | (e) The aggregate amount by which actual regulatory capital is less than the minimum regulatory capital requirement in all subsidiaries with regulatory capital requirements and the name(s) of the subsidiaries with such deficiencies. |
|--|--|

<sup>1</sup> Entities include securities, insurance and other financial subsidiaries, commercial subsidiaries (where permitted), significant minority equity investments in insurance, financial and commercial entities.

TABLE 15.2.—CAPITAL STRUCTURE

|                                |  |
|--------------------------------|--|
| Qualitative Disclosures .....  | (a) Summary information on the terms and conditions of the main features of all capital instruments, especially in the case of innovative, complex or hybrid capital instruments.  |
| Quantitative Disclosures ..... | (b) The amount of tier 1 capital, with separate disclosure of: <ol style="list-style-type: none"> <li>(1) common stock/surplus;</li> <li>(2) retained earnings;</li> <li>(3) minority interests in the equity of subsidiaries;</li> <li>(4) restricted core capital elements as defined in [the general risk-based capital rules];</li> <li>(5) amounts deducted from tier 1 capital, including goodwill and certain intangibles.</li> </ol> <p>(c) The total amount of tier 2 capital, with a separate disclosure of amounts deducted from tier 2 capital.</p> <p>(d) Other deductions from capital.</p> <p>(e) Total eligible capital.</p> |

TABLE 15.3.—CAPITAL ADEQUACY

|                                |   |
|--------------------------------|---|
| Qualitative Disclosures .....  | (a) A summary discussion of the [BANK]'s approach to assessing the adequacy of its capital to support current and future activities.  |
| Quantitative Disclosures ..... | (b) Risk-weighted assets for: <ol style="list-style-type: none"> <li>(1) Exposures to sovereign entities;</li> <li>(2) Exposures to certain supranational entities and MDBs;</li> <li>(3) Exposures to depository institutions, foreign banks, and credit unions;</li> <li>(4) Exposures to PSEs;</li> <li>(5) Corporate exposures;</li> <li>(6) Regulatory retail exposures;</li> <li>(7) Residential mortgage exposures;</li> <li>(8) Statutory multifamily mortgages and pre-sold construction loans;</li> <li>(9) Past due loans;</li> <li>(10) Other assets;</li> <li>(11) Securitization exposures; and</li> <li>(12) Equity exposures.</li> </ol> <p>(c) Risk-weighted assets for market risk as calculated under [the market risk rule]:<sup>1</sup></p> <ol style="list-style-type: none"> <li>(1) Standardized specific risk charge; and</li> <li>(2) Internal models approach for specific risk.</li> </ol> <p>(d) Risk-weighted assets for operational risk.</p> <p>(e) Total and tier 1 risk-based capital ratios:</p> <ol style="list-style-type: none"> <li>(1) For the top consolidated group; and</li> <li>(2) For each [BANK] subsidiary.</li> </ol> <p>(f) Total risk-weighted assets.</p> |

<sup>1</sup> Risk-weighted assets determined under [the market risk rule] are to be disclosed only for the approaches used.

**General qualitative disclosure requirement** describe its risk management objectives and policies.  
 For each separate risk area described in tables 15.4 through 15.10, the [BANK] must

TABLE 15.4.<sup>1</sup>—CREDIT RISK: GENERAL DISCLOSURES

|                                |   |
|--------------------------------|---|
| Qualitative Disclosures .....  | (a) The general qualitative disclosure requirement with respect to credit risk (excluding counterparty credit risk disclosed in accordance with Table 16.5), including: <ol style="list-style-type: none"> <li>(1) Definitions of past due and impaired (for accounting purposes);</li> <li>(2) Description of approaches followed for allowances, including statistical methods used where applicable;</li> <li>(3) Discussion of the [BANK]'s credit risk management policy.</li> </ol>   |
| Quantitative Disclosures ..... | (b) Total gross credit risk exposures and average credit risk exposures, after accounting offsets in accordance with GAAP, <sup>2</sup> and without taking into account the effects of credit risk mitigation techniques (for example, collateral and netting), over the period broken down by major types of credit exposure. For example, [BANK]s could apply a breakdown similar to that used for accounting purposes. Such a breakdown might, for instance, be loans, off-balance sheet commitments, and other non-derivative off-balance sheet exposures; debt securities; and OTC derivatives |
|                                | (c) Geographic <sup>3</sup> distribution of exposures, broken down in significant areas by major types of credit exposure.  |
|                                | (d) Industry or counterparty type distribution of exposures, broken down by major types of credit exposure.   |
|                                | (e) Remaining contractual maturity breakdown (for example, one year or less) of the whole portfolio, broken down by major types of credit exposure.   |
|                                | (f)(1) By major industry or counterparty type:  |



TABLE 15.4.<sup>1</sup>—CREDIT RISK: GENERAL DISCLOSURES—Continued

|  |  |
|--|--|
|  | <ul style="list-style-type: none"> <li>(2) Amount of impaired loans;</li> <li>(3) Amount of past due loans;<sup>4</sup></li> <li>(4) Allowances; and</li> <li>(5) Charge-offs during the period.</li> <li>(g) Amount of impaired loans and, if available, the amount of past due loans broken down by significant geographic areas including, if practical, the amounts of allowances related to each geographical area.<sup>5</sup></li> <li>(h) Reconciliation of changes in the allowance for loan and lease losses.<sup>6</sup></li> </ul> |
|--|--|

<sup>1</sup> Table 15.4 does not include equity exposures.

<sup>2</sup> For example, FASB Interpretations 39 and 41.

<sup>3</sup> Geographical areas may comprise individual countries, groups of countries, or regions within countries. A [BANK] might choose to define the geographical areas based on the way the [BANK]'s portfolio is geographically managed. The criteria used to allocate the loans to geographical areas must be specified.

<sup>4</sup> A [BANK] is encouraged also to provide an analysis of the aging of past-due loans.

<sup>5</sup> The portion of general allowance that is not allocated to a geographical area should be disclosed separately.

<sup>6</sup> The reconciliation should include the following: a description of the allowance; the opening balance of the allowance; charge-offs taken against the allowance during the period; amounts provided (or reversed) for estimated probable loan losses during the period; any other adjustments (for example, exchange rate differences, business combinations, acquisitions and disposals of subsidiaries), including transfers between allowances; and the closing balance of the allowance. Charge-offs and recoveries that have been recorded directly to the income statement should be disclosed separately.

TABLE 15.5.—GENERAL DISCLOSURE FOR COUNTERPARTY CREDIT RISK-RELATED EXPOSURES

|                                |  |
|--------------------------------|--|
| Qualitative Disclosures .....  | <ul style="list-style-type: none"> <li>(a) The general qualitative disclosure requirement with respect to OTC derivatives, eligible margin loans, and repo-style transactions, including:                             <ul style="list-style-type: none"> <li>(1) Discussion of methodology used to assign economic capital and credit limits for counterparty credit exposures;</li> <li>(2) Discussion of policies for securing collateral, valuing and managing collateral, and establishing credit reserves;</li> <li>(3) Discussion of the primary types of collateral taken;</li> <li>(4) Discussion of policies with respect to wrong-way risk exposures; and</li> <li>(5) Discussion of the impact of the amount of collateral the [BANK] would have to provide given a credit rating downgrade.</li> </ul> </li> </ul> |
| Quantitative Disclosures ..... | <ul style="list-style-type: none"> <li>(b) Gross positive fair value of contracts, netting benefits, netted current credit exposure, collateral held (including type, for example, cash, government securities), and net unsecured credit exposure.<sup>1</sup> Also report the notional value of credit derivative hedges purchased for counterparty credit risk protection and the distribution of current credit exposure by types of credit exposure.<sup>2</sup></li> <li>(c) Notional amount of purchased and sold credit derivatives, segregated between use for the [BANK]'s own credit portfolio, as well as in its intermediation activities, including the distribution of the credit derivative products used, broken down further by protection bought and sold within each product group.</li> </ul>             |

<sup>1</sup> Net unsecured credit exposure is the credit exposure after considering both the benefits from legally enforceable netting agreements and collateral arrangements without taking into account haircuts for price volatility, liquidity, etc.

<sup>2</sup> This may include interest rate derivative contracts, foreign exchange derivative contracts, equity derivative contracts, credit derivatives, commodity or other derivative contracts, repo-style transactions, and eligible margin loans.

TABLE 15.6.—CREDIT RISK MITIGATION<sup>1, 2, 3</sup>

|                                |   |
|--------------------------------|---|
| Qualitative Disclosures .....  | <ul style="list-style-type: none"> <li>(a) The general qualitative disclosure requirement with respect to credit risk mitigation including:                             <ul style="list-style-type: none"> <li>(1) policies and processes for, and an indication of the extent to which the [BANK] uses, on- and off-balance sheet netting;</li> <li>(2) policies and processes for collateral valuation and management;</li> <li>(3) a description of the main types of collateral taken by the [BANK];</li> <li>(4) the main types of guarantors/credit derivative counterparties and their creditworthiness; and</li> <li>(5) information about (market or credit) risk concentrations within the mitigation taken.</li> </ul> </li> </ul> |
| Quantitative Disclosures ..... | <ul style="list-style-type: none"> <li>(b) For each separately disclosed portfolio, the total exposure (after, where applicable, on- or off-balance sheet netting) that is covered by guarantees/credit derivatives and the risk-weighted asset amount associated with that exposure.</li> </ul>  |

<sup>1</sup> At a minimum, a [BANK] must give the disclosures in Table 15.6 in relation to credit risk mitigation that has been recognized for the purposes of reducing capital requirements under this appendix. Where relevant, [BANK]s are encouraged to give further information about mitigants that have not been recognized for that purpose.

<sup>2</sup> Credit derivatives that are treated, for the purposes of this appendix, as synthetic securitization exposures should be excluded from the credit risk mitigation disclosures and included within those relating to securitization.

<sup>3</sup> Counterparty credit risk-related exposures disclosed pursuant to Table 15.5 should be excluded from the credit risk mitigation disclosures in Table 15.6.

TABLE 15.7.—SECURITIZATION

|                               |   |
|-------------------------------|---|
| Qualitative Disclosures ..... | <ul style="list-style-type: none"> <li>(a) The general qualitative disclosure requirement with respect to securitization (including synthetic securitizations), including a discussion of:                             <ul style="list-style-type: none"> <li>(1) the [BANK]'s objectives relating to securitization activity, including the extent to which these activities transfer credit risk of the underlying exposures away from the [BANK] to other entities;</li> <li>(2) the roles played by the [BANK] in the securitization process<sup>1</sup> and an indication of the extent of the [BANK]'s involvement in each of them.</li> </ul> </li> <li>(b) Summary of the [BANK]'s accounting policies for securitization activities, including:</li> </ul> |
|-------------------------------|---|

TABLE 15.7.—SECURITIZATION—Continued

|                                |  |
|--------------------------------|--|
| Quantitative Disclosures ..... | <ul style="list-style-type: none"> <li>(1) whether the transactions are treated as sales or financings;</li> <li>(2) recognition of gain-on-sale;</li> <li>(3) key assumptions for valuing retained interests, including any significant changes since the last reporting period and the impact of such changes; and</li> <li>(4) treatment of synthetic securitizations.</li> <li>(c) Names of NRSROs used for securitizations and the types of securitization exposure for which each organization is used.</li> <li>(d) The total outstanding exposures securitized by the [BANK] in securitizations that meet the operation criteria in Section 41 (broken down into traditional/synthetic), by underlying exposure type.<sup>2,3,4</sup></li> <li>(e) For exposures securitized by the [BANK] in securitizations that meet the operational criteria in Section 41:             <ul style="list-style-type: none"> <li>(1) amount of securitized assets that are impaired/past due; and</li> <li>(2) losses recognized by the [BANK] during the current period<sup>5</sup> broken down by exposure type.</li> </ul> </li> <li>(f) Aggregate amount of securitization exposures broken down by underlying exposure type.</li> <li>(g) Aggregate amount of securitization exposures and the associated capital charges for these exposures by risk-weight category. Exposures that have been deducted from capital should be disclosed separately by type of underlying asset.</li> <li>(h) For securitizations subject to the early amortization treatment, the following items by underlying asset type for securitized facilities:             <ul style="list-style-type: none"> <li>(1) the aggregate drawn exposures attributed to the seller's and investors' interests; and</li> <li>(2) the aggregate capital charges incurred by the [BANK] against the investor's shares of drawn balances and undrawn lines.</li> </ul> </li> <li>(i) Summary of current year's securitization activity, including the amount of exposures securitized (by exposure type), and recognized gain-or loss-on-sale by asset type.</li> </ul> |
|--------------------------------|--|

<sup>1</sup> For example: originator, investor, servicer, provider of credit enhancement, sponsor of asset-backed commercial paper facility, liquidity provider, swap provider.

<sup>2</sup> Underlying exposure types may include, for example, mortgage loans secured by liens on one-to-four family residential property, home equity lines, credit card receivables, and auto loans.

<sup>3</sup> Securitization transactions in which the originating [BANK] does not retain any securitization exposure should be shown separately but need only be reported for the year of inception.

<sup>4</sup> Where relevant, a [BANK] is encouraged to differentiate between exposures resulting from activities in which they act only as sponsors, and exposures that result from all other [BANK] securitization activities.

<sup>5</sup> For example, charge-offs/allowances (if the assets remain on the [BANK]'s balance sheet) or write-downs of I/O strips and other residual interests.

TABLE 15.8.—OPERATIONAL RISK

|                               |   |
|-------------------------------|---|
| Qualitative disclosures ..... | <ul style="list-style-type: none"> <li>(a) The general qualitative disclosure requirement for operational risk.</li> <li>(b) A description of the use of insurance for the purpose of mitigating operational risk.</li> </ul> |
|-------------------------------|---|

TABLE 15.9.—EQUITIES NOT SUBJECT TO MARKET RISK RULE

|                                |   |
|--------------------------------|---|
| Qualitative Disclosures .....  | <ul style="list-style-type: none"> <li>(a) The general qualitative disclosure requirement with respect to equity risk, including:             <ul style="list-style-type: none"> <li>(1) differentiation between holdings on which capital gains are expected and those taken under other objectives including for relationship and strategic reasons; and</li> <li>(2) discussion of important policies covering the valuation of and accounting for equity holdings in the banking book. This includes the accounting techniques and valuation methodologies used, including key assumptions and practices affecting valuation as well as significant changes in these practices.</li> </ul> </li> </ul>  |
| Quantitative Disclosures ..... | <ul style="list-style-type: none"> <li>(b) Value disclosed in the balance sheet of investments, as well as the fair value of those investments; for quoted securities, a comparison to publicly-quoted share values where the share price is materially different from fair value.</li> <li>(c) The types and nature of investments, including the amount that is:             <ul style="list-style-type: none"> <li>(1) Publicly traded; and</li> <li>(2) Non-publicly traded.</li> </ul> </li> <li>(d) The cumulative realized gains (losses) arising from sales and liquidations in the reporting period.</li> <li>(e)(1) Total unrealized gains (losses)<sup>1</sup></li> <li style="padding-left: 20px;">(2) Total latent revaluation gains (losses)<sup>2</sup></li> <li style="padding-left: 20px;">(3) Any amounts of the above included in tier 1 and/or tier 2 capital.</li> <li>(f) Capital requirements broken down by appropriate equity groupings, consistent with the [BANK]'s methodology, as well as the aggregate amounts and the type of equity investments subject to any supervisory transition regarding regulatory capital requirements.</li> </ul> |

<sup>1</sup> Unrealized gains (losses) recognized in the balance sheet but not through earnings.

<sup>2</sup> Unrealized gains (losses) not recognized either in the balance sheet or through earnings.

TABLE 15.10.—INTEREST RATE RISK FOR NON-TRADING ACTIVITIES

|                                |   |
|--------------------------------|---|
| Qualitative disclosures .....  | <ul style="list-style-type: none"> <li>(a) The general qualitative disclosure requirement, including the nature of interest rate risk for non-trading activities and key assumptions, including assumptions regarding loan prepayments and behavior of non-maturity deposits, and frequency of measurement of interest rate risk for non-trading activities.</li> </ul> |
| Quantitative disclosures ..... | <ul style="list-style-type: none"> <li>(b) The increase (decline) in earnings or economic value (or relevant measure used by management) for upward and downward rate shocks according to management's method for measuring interest rate risk for non-trading activities, broken down by currency (as appropriate).</li> </ul>   |

END OF COMMON RULE.  
[END OF COMMON TEXT]

**List of Subjects**

*12 CFR Part 3*

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

*12 CFR Part 208*

Confidential business information, Crime, Currency, Federal Reserve System, Mortgages, Reporting and recordkeeping requirements, Securities.

*12 CFR Part 225*

Administrative practice and procedure, Banks, banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

*12 CFR Part 325*

Administrative practice and procedure, Banks, banking, Capital Adequacy, Reporting and recordkeeping requirements, Savings associations, State nonmember banks.

*12 CFR Part 567*

Capital, Reporting and recordkeeping requirements, Savings associations.

**Proposed Adoption of Common Appendix**

The proposed adoption of the common rules by the agencies, as modified by agency-specific text, is set forth below:

**Department of the Treasury**

**Office of the Comptroller of the Currency**

**12 CFR Chapter I**

**Authority and Issuance**

For the reasons stated in the common preamble, the Office of the Comptroller of the Currency amends Part 3 of chapter I of Title 12, Code of Federal Regulations as follows:

**PART 3—MINIMUM CAPITAL RATIOS; ISSUANCE OF DIRECTIVES**

1. The authority citation for part 3 continues to read as follows:

**Authority:** 12 U.S.C. 93a, 161, 1818, 1828(n), 1828 note, 1831n note, 1835, 3907, and 3909.

2. New Appendix D to part 3 is added as set forth at the end of the common preamble.

3. Appendix D to part 3 is amended as set forth below:  
a. Remove “[agency]” and add “OCC” in its place wherever it appears.  
b. Remove “[BANK]” and add “bank” in its place wherever it appears, and

remove “[Banks]” and add “Banks” in its place wherever it appears.

c. Remove “[Appendix to Part ]” and add “Appendix D to Part 3” in its place wherever it appears.

d. Remove “[the general risk-based capital rules]” and add “12 CFR part 3, appendix A” in its place wherever it appears.

e. Remove “[the market risk rule]” and add “12 CFR part 3, appendix B” in its place wherever it appears.

f. Remove “[the advanced approaches risk-based capital rules]” and add “12 CFR part 3, appendix C” in its place wherever it appears.

g. In section 1, revise paragraph (e) to read as follows:

**Section 1. Purpose, Applicability, Election Procedures, and Reservation of Authority**

(e) *Notice and response procedures.* In making a determination under paragraphs (c)(3) or (d) of this section, the OCC will apply notice and response procedures in the same manner as the notice and response procedures in 12 CFR 3.12.

h. In section 2, revise the definitions of gain-on-sale, pre-sold construction loan, statutory multifamily mortgage, and paragraph (7) of the definition of traditional securitization to read as follows:

**Section 2. Definitions**

*Gain-on-sale* means an increase in the equity capital (as reported on Schedule RC of the Consolidated Statement of Condition and Income (Call Report)) of a bank that results from a securitization (other than an increase in equity capital that results from the bank’s receipt of cash in connection with the securitization). (See also *securitization*.)

*Pre-sold construction loan* means any one-to-four family residential pre-sold construction loan for a residence meeting the requirements under section 618(a)(1) or (2) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 (RTCRI Act) and under 12 CFR part 3, appendix A, section 3(a)(3)(iv).

*Statutory multifamily mortgage* means any multifamily residential mortgage meeting the requirements under section 618(b)(1) of the RTCRI Act, and under 12 CFR part 3, appendix A, section 3(a)(3)(v).

*Traditional securitization* \* \* \* (7) The underlying exposures are not owned by a firm an investment in which qualifies as a community development investment under 12 U.S.C. 24(Eleventh);

i. In section 21, revise paragraph (a)(1) and (a)(2) to read as follows:

**Section 21. Modifications to Tier 1 and Tier 2 Capital**

(a) \* \* \* (1) A bank is not required to make the deductions from capital for CEIOs in 12 CFR part 3, appendix A, section 2(c)(1)(iv).

(2) A bank is not required to make the deductions from capital for nonfinancial equity investments in 12 CFR part 3, appendix A, section 2(c)(1)(v).

j. In section 33, revise paragraphs (c)(2) and (g)(3)(iv)(B) to read as follows:

**Section 33. General Risk Weights**

(2) A bank must assign a risk weight of at least 100 percent to an exposure to a depository institution or a foreign bank that is includable in the depository institution’s or foreign bank’s regulatory capital and that is not subject to deduction as a reciprocal holding pursuant to 12 CFR part 3, appendix A, section 2(c)(6)(ii).

(B) A bank must base all estimates of a property’s value on an appraisal or evaluation of the property that satisfies subpart C of 12 CFR part 34.

k. Revise paragraph (i)(1)(iv) and paragraph (i)(4) of section 42 to read as follows:

**Section 42. Risk-Weighted Assets for Securitization Exposures**

(iv) The bank is well capitalized, as defined in the OCC’s prompt corrective action regulation at 12 CFR part 6. For purposes of determining whether a bank is well capitalized for purposes of this paragraph, the bank’s capital ratios must be calculated without regard to the capital treatment for transfers of small-business obligations with recourse specified in paragraph (i)(1) of this section.

(4) The risk-based capital ratios of the bank must be calculated without regard to the capital treatment for transfers of small-business obligations with recourse specified in paragraph (i)(1) of this section as provided in 12 CFR part 3, appendix A.

l. In section 52, revise paragraph (b)(3)(i) to read as follows:

**Section 52. Simple Risk-Weight Approach (SRWA)**

(i) *Community development exposures.* An equity exposure that qualifies as a community development investment under 12 U.S.C. 24(Eleventh), excluding equity exposures to an unconsolidated small

business investment company and equity exposures held through a consolidated small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682).

\* \* \* \* \*

m. In section 61, revise paragraph (c) to read as follows:

**Section 61. Basic Indicator Approach**

\* \* \* \* \*

(c) *Annual gross income.* A bank's annual gross income equals its net interest income plus its total noninterest income minus its underwriting income from insurance and reinsurance activities as reported on the bank's Call Report.

\* \* \* \* \*

n. In section 71, revise paragraph (b) to read as follows:

**Section 71. Disclosure Requirements**

\* \* \* \* \*

(b) A bank must comply with paragraph (c) of section 71 of appendix H to the Federal Reserve Board's Regulation Y (12 CFR part 225, appendix H), including Tables 15.1—15.10, unless it is a consolidated subsidiary of a bank holding company or depository institution that is subject to these requirements.

\* \* \* \* \*

o. In section 71, remove paragraph (c) and Tables 15.1—15.10.

**Board of Governors of the Federal Reserve System**

**12 CFR Chapter II**

**Authority and Issuance**

For the reasons stated in the common preamble, the Board of Governors of the Federal Reserve System amends parts 208 and 225 of chapter II of title 12 of the Code of Federal Regulations as follows:

**PART 208—MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM (REGULATION H)**

1. The authority citation for part 208 continues to read as follows:

**Authority:** 12 U.S.C. 24, 36, 92a, 93a, 248(a), 248(c), 321–338a, 371d, 461, 481–486, 601, 611, 1814, 1816, 1818, 1820(d)(9), 1823(j), 1828(o), 1831, 1831o, 1831p–1, 1831r–1, 1835a, 1882, 2901–2907, 3105, 3310, 3331–3351, and 3906–3909; 15 U.S.C. 78b, 78l(b), 78l(g), 78l(i), 78o–4(c)(5), 78q, 78q–1, and 78w, 6801, and 6805; 31 U.S.C. 5318; 42 U.S.C. 4012a, 4104a, 4104b, 4106, and 4128.

2. New Appendix G to part 208 is added as set forth at the end of the common preamble.

3. Appendix G to part 208 is amended as set forth below:

a. Remove “[agency]” and add “Federal Reserve” in its place wherever it appears.

b. Remove “[BANK]” and add “bank” in its place wherever it appears, and remove “[Banks]” and add “Banks” in its place wherever it appears.

c. Remove “[Appendix \_\_ to Part \_\_]” and add “Appendix G to Part 208” in its place wherever it appears.

d. Remove “[the general risk-based capital rules]” and add “12 CFR part 208, appendix A” in its place wherever it appears.

e. Remove “[the market risk rule]” and add “12 CFR part 208, appendix E” in its place wherever it appears.

f. Remove “[the advanced approaches risk-based capital rules]” and add “12 CFR part 208, appendix F” in its place wherever it appears.

g. In section 1, revise paragraph (e) to read as follows:

**Section 1. Purpose, Applicability, Election Procedures, and Reservation of Authority**

\* \* \* \* \*

(e) *Notice and response procedures.* In making a determination under paragraphs (c)(3) or (d) of this section, the Federal Reserve will apply notice and response procedures in the same manner as the notice and response procedures in 12 CFR 263.202.

\* \* \* \* \*

h. In section 2, revise the definitions of gain-on-sale, pre-sold construction loan, statutory multifamily mortgage, and paragraph (7) of the definition of traditional securitization to read as follows:

**Section 2. Definitions**

\* \* \* \* \*

*Gain-on-sale* means an increase in the equity capital (as reported on Schedule RC of the Consolidated Statement of Condition and Income (Call Report)) of a bank that results from a securitization (other than an increase in equity capital that results from the bank's receipt of cash in connection with the securitization). (See also *securitization*.)

\* \* \* \* \*

*Pre-sold construction loan* means any one-to-four family residential pre-sold construction loan for a residence meeting the requirements under section 618(a)(1) or (2) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 (RTCRI Act) and under 12 CFR part 208, appendix A, section III.C.3.

\* \* \* \* \*

*Statutory multifamily mortgage* means any multifamily residential mortgage meeting the requirements under section 618(b)(1) of the RTCRI Act and under 12 CFR part 208, appendix A, section III.C.3.

\* \* \* \* \*

*Traditional securitization* \* \* \*

(7) The underlying exposures are not owned by a firm an investment in which qualifies as a community development investment under 12 U.S.C. 24 (Eleventh);

\* \* \* \* \*

i. In section 21, revise paragraphs (a)(1) and (2) to read as follows:

**Section 21. Modifications to Tier 1 and Tier 2 Capital**

(a) \* \* \*

(1) A bank is not required to make the deductions from capital for CEIOs in 12 CFR part 208, appendix A, section II.B.1.e.

(2) A bank is not required to make the deductions from capital for nonfinancial equity investments in 12 CFR part 208, appendix A, section II.B.5.

\* \* \* \* \*

j. In section 33, revise paragraphs (c)(2) and (g)(3)(iv)(B) to read as follows:

**Section 33. General Risk Weights**

\* \* \* \* \*

(c) \* \* \*

(2) A bank must assign a risk weight of at least 100 percent to an exposure to a depository institution or a foreign bank that is includable in the depository institution's or foreign bank's regulatory capital and that is not subject to deduction as a reciprocal holding pursuant to 12 CFR part 208, appendix A, section II.B.3.

\* \* \* \* \*

(g) \* \* \*

(3) \* \* \*

(iv) \* \* \*

(B) A bank must base all estimates of a property's value on an appraisal or evaluation of the property that satisfies subpart E of 12 CFR part 208.

\* \* \* \* \*

k. Revise paragraph (i)(1)(iv) and paragraph (i)(4) of section 42 to read as follows:

**Section 42. Risk-Weighted Assets for Securitization Exposures**

\* \* \* \* \*

(i) \* \* \*

(1) \* \* \*

(iv) The bank is well capitalized, as defined in the Federal Reserve's prompt corrective action regulation at 12 CFR part 208, Subpart D. For purposes of determining whether a bank is well capitalized for purposes of this paragraph, the bank's capital ratios must be calculated without regard to the capital treatment for transfers of small-business obligations with recourse specified in paragraph (i)(1) of this section.

\* \* \* \* \*

(4) The risk-based capital ratios of the bank must be calculated without regard to the capital treatment for transfers of small-business obligations with recourse specified in paragraph (i)(1) of this section as provided in 12 CFR part 208, appendix A.

\* \* \* \* \*

l. In section 52, revise paragraph (b)(3)(i) to read as follows:

**Section 52. Simple Risk-Weight Approach (SRWA)**

\* \* \* \* \*

(b) \* \* \*

(3) \* \* \*

(i) *Community development exposures.* An equity exposure that qualifies as a community development investment under 12 U.S.C. 24 (Eleventh), excluding equity exposures to an unconsolidated small

business investment company and equity exposures held through a consolidated small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682).

\* \* \* \* \*

m. In section 61, revise paragraph (c) to read as follows:

**Section 61. Basic Indicator Approach**

\* \* \* \* \*

(c) *Annual gross income.* A bank's annual gross income equals its net interest income plus its total noninterest income minus its underwriting income from insurance and reinsurance activities as reported on the bank's Call Report.

\* \* \* \* \*

n. In section 71, revise paragraph (b) to read as follows:

**Section 71. Disclosure Requirements**

\* \* \* \* \*

(b) A bank must comply with paragraph (c) of section 71 of appendix H to the Federal Reserve Board's Regulation Y (12 CFR part 225, appendix H), including Tables 15.1–15.10, unless it is a consolidated subsidiary of a bank holding company or depository institution that is subject to these requirements.

\* \* \* \* \*

o. In section 71, remove paragraph (c) and remove Tables 15.1–15.10.

**PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)**

1. The authority citation for part 225 continues to read as follows:

**Authority:** 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831i, 1831p–1, 1843(c)(8), 1844(b), 1972(1), 3106, 3108, 3310, 3331–3351, 3907, and 3909; 15 U.S.C. 6801 and 6805.

2. New Appendix H to part 225 is added as set forth at the end of the common preamble.

3. Appendix H to part 225 is amended as set forth below:

a. Remove “[agency]” and add “Federal Reserve” in its place wherever it appears.

b. Remove “[BANK]” and add in its place “bank holding company” wherever it appears, and remove “[Banks]” and add “Bank Holding Companies” in its place wherever it appears.

c. Remove “[Appendix \_\_ to Part \_\_]” and add “Appendix H to Part 225” in its place wherever it appears.

d. Remove “[the general risk-based capital rules]” and add “12 CFR part 225, appendix A” in its place wherever it appears.

e. Remove “[the market risk rule]” and add “12 CFR part 225, appendix E” in its place wherever it appears.

f. Remove “[the advanced approaches risk-based capital rules]” and add “12

CFR part 225, appendix G” in its place wherever it appears.

g. In section 1, revise paragraphs (b) and (e) to read as follows:

**Section 1. Purpose, Applicability, Election Procedures, and Reservation of Authority**

\* \* \* \* \*

(b) *Applicability.* This appendix applies to a bank holding company that elects to use this appendix to calculate its risk-based capital requirements and that is not a consolidated subsidiary of another bank holding company that uses this appendix to calculate its risk-based capital requirements.

\* \* \* \* \*

(e) *Notice and response procedures.* In making a determination under paragraphs (c)(3) or (d) of this section, the Federal Reserve will apply notice and response procedures in the same manner as the notice and response procedures in 12 CFR 263.202.

\* \* \* \* \*

h. In section 2, revise the definitions of gain-on-sale, pre-sold construction loan, statutory multifamily mortgage, and paragraph (7) of the definition of traditional securitization to read as follows:

**Section 2. Definitions**

\* \* \* \* \*

*Gain-on-sale* means an increase in the equity capital (as reported on Schedule HC of the FR Y–9C Report) of a bank holding company that results from a securitization (other than an increase in equity capital that results from the bank holding company's receipt of cash in connection with the securitization). (See also *securitization*.)

\* \* \* \* \*

*Pre-sold construction loan* means any one-to-four family residential pre-sold construction loan for a residence meeting the requirements under section 618(a)(1) or (2) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 (RTCRI Act) and under 12 CFR part 225, appendix A, section III.C.3.

\* \* \* \* \*

*Statutory multifamily mortgage* means any multifamily residential mortgage meeting the requirements under section 618(b)(1) of the RTCRI Act and under 12 CFR part 225, appendix A, section III.C.3.

\* \* \* \* \*

*Traditional securitization* \* \* \*

(7) The underlying exposures are not owned by a firm an investment in which qualifies as a community development investment under 12 U.S.C. 24(Eleventh);

\* \* \* \* \*

i. In section 21, revise paragraphs (a)(1) and (2) and add a new paragraph (c)(4) to read as follows:

**Section 21. Modifications to Tier 1 and Tier 2 Capital**

(a) \* \* \*

(1) A bank holding company is not required to make the deductions from capital for CEOs in 12 CFR part 225, appendix A, section II.B.1.e.

(2) A bank holding company is not required to make the deductions from capital for nonfinancial equity investments in 12 CFR part 225, appendix A, section II.B.5.

\* \* \* \* \*

(c) \* \* \*

(4) A bank holding company must also deduct an amount equal to the minimum regulatory capital requirement established by the regulator of any insurance underwriting subsidiary of the holding company. For U.S.-based insurance underwriting subsidiaries, this amount generally would be 200 percent of the subsidiary's Authorized Control Level as established by the appropriate state regulator of the insurance company.

j. In section 33, revise paragraph (c)(2) to read as follows:

**Section 33. General Risk Weights**

\* \* \* \* \*

(c) \* \* \*

(2) A bank holding company must assign a risk weight of at least 100 percent to an exposure to a depository institution or a foreign bank that is includable in the depository institution's or foreign bank's regulatory capital and that is not subject to deduction as a reciprocal holding pursuant to 12 CFR part 225, appendix A, section II.B.3.

\* \* \* \* \*

k. In paragraph (k)(1) of section 33, remove “A [BANK] may assign a zero percent risk weight to cash owned and held in all offices of the [BANK] or in transit; to gold bullion held in the [BANK]'s own vaults, or held in another depository institution's vaults on an allocated basis, to the extent the gold bullion assets are offset by gold bullion liabilities;” and add in its place “A bank holding company may assign a zero percent risk weight to cash owned and held in all offices of subsidiary depository institutions or in transit; to gold bullion held in either a subsidiary depository institution's own vaults, or held in another depository institution's vaults on an allocated basis, to the extent the gold bullion assets are offset by gold bullion liabilities;”

\* \* \* \* \*

l. Revise paragraph (i)(1)(iv) and revise paragraph (i)(4) of section 42 to read as follows:

**Section 42. Risk-Weighted Assets for Securitization Exposures**

\* \* \* \* \*

(i) \* \* \*

(1) \* \* \*

(iv) The bank holding company is well capitalized, as defined in the Federal Reserve's prompt corrective action regulation at 12 CFR part 208, Subpart D. For purposes of determining whether a bank holding company is well capitalized for purposes of this paragraph, the bank holding company's capital ratios must be calculated without regard to the capital treatment for transfers of

small-business obligations with recourse specified in paragraph (i)(1) of this section.

(4) The risk-based capital ratios of the bank holding company must be calculated without regard to the capital treatment for transfers of small-business obligations with recourse specified in paragraph (i)(1) of this section as provided in 12 CFR part 225, appendix A.

m. In section 52, revise paragraph (b)(3)(i) to read as follows:

Section 52. Simple Risk-Weight Approach (SRWA)

(b) (3) (i) Community development exposures. An equity exposure that qualifies as a community development investment under 12 U.S.C. 24(Eleventh), excluding equity exposures to an unconsolidated small business investment company and equity exposures held through a consolidated small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682).

(c) In section 61, revise paragraph (c) to read as follows:

Section 61. Basic Indicator Approach

(c) Annual gross income. A bank holding company's annual gross income equals its net interest income plus its total noninterest income minus its underwriting income from insurance and reinsurance activities as reported on the bank holding company's Y-9C Report.

Federal Deposit Insurance Corporation 12 CFR Chapter III

Authority and Issuance

For the reasons stated in the common preamble, the Federal Deposit Insurance Corporation amends part 325 of chapter III of Title 12, Code of Federal Regulations as follows:

PART 325—CAPITAL MAINTENANCE

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

Authority: 12 U.S.C. 1815(a), 1815(b), 1816, 1818(a), 1818(b), 1818(t), 1819(Tenth), 1828(c), 1828(d), 1828(i), 1828(n), 1828(o), 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, 2386 (12 U.S.C. 1828 note).

2. New Appendix E to part 325 is added as set forth at the end of the common preamble.

3. Appendix E to part 325 is amended as set forth below:

- a. Remove "[agency]" and add "FDIC" in its place wherever it appears.
b. Remove "[BANK]" and add "bank" in its place wherever it appears, and

remove "[Banks]" and add "Banks" in its place wherever it appears.

c. Remove "[Appendix \_\_ to Part \_\_]" and add "Appendix E to Part 325" in its place wherever it appears.

d. Remove "[the general risk-based capital rules]" and add "12 CFR part 325, appendix A" in its place wherever it appears.

e. Remove "[the market risk rule]" and add "12 CFR part 325, appendix C" in its place wherever it appears.

f. Remove "[the advanced approaches risk-based capital rules]" and add "12 CFR part 325, appendix D" in its place wherever it appears.

g. In section 1, revise paragraph (e) to read as follows:

Section 1. Purpose, Applicability, Election Procedures, and Reservation of Authority

(e) Notice and response procedures. In making a determination under paragraphs (c)(3) or (d) of this section, the FDIC will apply notice and response procedures in the same manner as the notice and response procedures in 12 CFR 325.6(c).

h. In section 2, revise the definitions of gain-on-sale, pre-sold construction loan, statutory multifamily mortgage, and paragraph (7) of the definition of traditional securitization to read as follows:

Section 2. Definitions

Gain-on-sale means an increase in the equity capital (as reported on Schedule RC of the Consolidated Statement of Condition and Income (Call Report)) of a bank that results from a securitization (other than an increase in equity capital that results from the bank's receipt of cash in connection with the securitization). (See also securitization.)

Pre-sold construction loan means any one-to-four family residential pre-sold construction loan for a residence meeting the requirements under section 618(a)(1) or (2) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 (RTCRI Act) and under 12 CFR part 325, appendix A, section II.C, and that is not 90 days or more past due or on nonaccrual.

Statutory multifamily mortgage means any multifamily residential mortgage meeting the requirements under section 618(b)(1) of the RTCRI Act and under 12 CFR part 325, appendix A, section II.C.

Traditional securitization (7) The underlying exposures are not owned by a firm an investment in which qualifies as a community development investment under 12 U.S.C. 24(Eleventh);

i. In section 21, revise paragraph (a)(1) and (a)(2) to read as follows:

Section 21. Modifications to Tier 1 and Tier 2 Capital

(1) A bank is not required to make the deductions from capital for CEIOs in 12 CFR part 325, appendix A, section II.B.5.

(2) A bank is not required to make the deductions from capital for nonfinancial equity investments in 12 CFR part 325, appendix A, section II.B.

j. In section 33, revise paragraphs (c)(2) and (g)(3)(iv)(B) to read as follows:

Section 33. General Risk Weights

(2) A bank must assign a risk weight of at least 100 percent to an exposure to a depository institution or a foreign bank that is includable in the depository institution's or foreign bank's regulatory capital and that is not subject to deduction as a reciprocal holding pursuant to 12 CFR part 325, appendix A, section I.B.(4).

(g) (3) (iv) (B) A bank must base all estimates of a property's value on an appraisal or evaluation of the property that satisfies 12 CFR part 323.

k. Revise paragraph (i)(1)(iv) and paragraph (i)(4) of section 42 to read as follows:

Section 42. Risk-Weighted Assets for Securitization Exposures

(iv) The bank is well capitalized, as defined in the FDIC's prompt corrective action regulation at 12 CFR part 325, subpart B. For purposes of determining whether a bank is well capitalized for purposes of this paragraph, the bank's capital ratios must be calculated without regard to the capital treatment for transfers of small-business obligations with recourse specified in paragraph (i)(1) of this section.

(4) The risk-based capital ratios of the bank must be calculated without regard to the capital treatment for transfers of small-business obligations with recourse specified in paragraph (i)(1) of this section as provided in 12 CFR part 325, appendix A.

l. In section 52, revise paragraph (b)(3)(i) to read as follows:

Section 52. Simple Risk-Weight Approach (SRWA)

(i) Community development exposures. An equity exposure that qualifies as a community development investment under 12 U.S.C. 24(Eleventh), excluding equity exposures to an unconsolidated small

business investment company and equity exposures held through a consolidated small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682).

\* \* \* \* \*

m. In section 61, revise paragraph (c) to read as follows:

**Section 61. Basic Indicator Approach**

\* \* \* \* \*

(c) *Annual gross income.* A bank's annual gross income equals its net interest income plus its total noninterest income minus its underwriting income from insurance and reinsurance activities as reported on the bank's Call Report.

\* \* \* \* \*

n. In section 71, revise paragraph (b) to read as follows:

**Section 71. Disclosure Requirements**

\* \* \* \* \*

(b) A bank must comply with paragraph (c) of section 71 of appendix H to the Federal Reserve Board's Regulation Y (12 CFR part 225, appendix H), including Tables 15.1–15.10, unless it is a consolidated subsidiary of a bank holding company or depository institution that is subject to these requirements.

\* \* \* \* \*

o. In section 71, remove paragraph (c) and Tables 15.1–15.10.

**Department of the Treasury  
Office of Thrift Supervision  
12 CFR Chapter V**

**Authority and Issuance**

For the reasons stated in the common preamble, the Office of Thrift Supervision amends Part 567 of chapter V of Title 12, Code of Federal Regulations as follows:

**PART 567—CAPITAL**

1. The authority citation for part 567 continues to read as follows:

**Authority:** 12 U.S.C. 1462, 1462a, 1463, 1464, 1467a, 1828(note).

2. In § 567.0, revise paragraph (a), redesignate paragraph (b) as paragraph (c), add new paragraph (b), and amend redesignated paragraph (c) by adding a new heading and by revising paragraph (c)(2)(ii) to read as follows:

**§ 567.0 Scope.**

(a) *General.* This part prescribes the minimum regulatory capital requirements for savings associations. Subpart B of this part applies to all savings associations, except as described in paragraphs (b) and (c) of this section.

(b) *Savings associations using the standardized approach rule.* (1) A savings association that uses Appendix B of this part must utilize the

methodologies in that appendix to calculate their risk based capital requirement and make the required disclosures described in that appendix.

(2) Subpart B of this part does not apply to the computation of risk-based capital requirements by a savings association that uses Appendix B of this part. However, these savings associations:

(i) Must compute the components of capital under § 567.5 subject to the modifications in section 21 of Appendix B of this part.

(ii) Must meet the leverage ratio requirement described at §§ 567.2(a)(2) and 567.8. Notwithstanding paragraph (b)(2)(i) of this section, the savings association must compute core (tier 1) capital under section 567.5.

(iii) Must meet the tangible capital requirement described at §§ 567.2(a)(3) and 567.9.

(iv) Are subject to §§ 567.3 (individual minimum capital requirement), 567.4 (capital directives); and 567.10 (consequences of failure to meet capital requirements).

(v) Are subject to the reservations of authority at § 567.11, which supplement the reservations of authority at section 1 of Appendix B of this part.

(c) *Savings associations using the advanced approaches rule.*

\* \* \* \* \*

(2) \* \* \*

(ii) Must meet the leverage ratio requirement described at §§ 567.2(a)(2) and 567.8. Notwithstanding paragraph (c)(2)(i) of this section, the savings association must compute core (tier 1) capital under section 567.5.

\* \* \* \* \*

2. Appendix B is added to part 567 as set forth at the end of the common preamble.

3. Amend Appendix B of part 567 as follows:

a. Revise the heading of Appendix B to read as follows:

**Appendix B to Part 567—Risk-Based Capital Requirements—Standardized Framework**

b. Remove [agency] and add “OTS” in its place wherever it appears.

c. Remove “[BANK]” and add “savings association” in its place wherever it appears, and remove “[Banks]” and add “Savings Associations” in its place wherever it appears.

d. Remove “[Appendix \_\_ to Part \_\_]” and add “Appendix B to Part 567” in its place wherever it appears.

e. Remove “[the general risk-based capital rules]” and add “subpart B of part 567” in its place wherever it appears.

f. Remove “[the market risk rule]” and add “any applicable market risk rule” in its place wherever it appears.

g. Remove “[the advanced approaches risk-based capital rules]” and add “Appendix C to Part 567” in its place wherever it appears.

h. In section 1, revise paragraph (e) to read as follows:

**Section 1. Purpose, Applicability, Election Procedures, and Reservation of Authority**

\* \* \* \* \*

(e) *Notice and response procedures.* In making a determination under paragraphs (c)(3) or (d) of this section, the [agency] will apply notice and response procedures in the same manner as the notice and response procedures in 12 CFR 567.3(d).

\* \* \* \* \*

i. In section 2, revise the definitions of gain-on-sale, pre-sold construction loan, statutory multifamily loan, and paragraph (7) of the definition of traditional securitization to read as follows:

**Section 2. Definitions**

\* \* \* \* \*

*Gain-on-sale* means an increase in the equity capital (as reported on Schedule SC of the Thrift Financial Report) of a savings association that results from a securitization (other than an increase in equity capital that results from the savings association's receipt of cash in connection with the securitization). (See also *securitization*.)

\* \* \* \* \*

*Pre-sold construction loan* means any one-to-four family residential pre-sold construction loan for a residence meeting the requirements under section 618(a)(1) or (2) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 (RTCRI Act) and 12 CFR 567.1 (definition of “qualifying residential construction loan”), and that is not on nonaccrual.

\* \* \* \* \*

*Statutory multifamily mortgage* means any multifamily residential mortgage that:

- (1) Meets the requirements under section 618(b)(1) of the RTCRI Act and under 12 CFR 567.1 (definition of “qualifying multifamily mortgage loan”) and 12 CFR 567.6(a)(1)(iii); and
- (2) Is not on nonaccrual.

\* \* \* \* \*

*Traditional securitization* \* \* \*

(7) The underlying exposures are not owned by a firm an investment in which is designed primarily to promote community welfare, including the welfare of low- and moderate-income communities or families, such as by providing services or jobs.

\* \* \* \* \*

j. Revise paragraphs (a)(1) and (2) of section 21 to read as follows:

**Section 21. Modifications to Tier 1 and Tier 2 Capital**

\* \* \* \* \*

(a) \* \* \*



(1) A savings association is not required to make the deductions from capital for CEOs in 12 CFR 567.5(a)(2)(iii) and 567.12(e);

(2) A savings association is not required to deduct equity securities from capital under 12 CFR 567.5(c)(2)(ii). However, it must continue to deduct equity investments in real estate under that section. See 12 CFR 567.1, which defines equity investments, including equity securities and equity investments in real estate.

\* \* \* \* \*

k. Revise paragraphs (c)(2) and (g)(3)(iv)(B) of section 33 to read as follows:

**Section 33. General Risk Weights**

\* \* \* \* \*

(c) \* \* \*

(2) A savings association must assign a risk weight of at least 100 percent to an exposure to a depository institution or a foreign bank that is includable in the depository institution's or foreign bank's regulatory capital and that is not subject to deduction as a reciprocal holding pursuant to 12 CFR part 567.5(c)(2)(i).

\* \* \* \* \*

(g) \* \* \*

(3) \* \* \*

(iv) \* \* \*

(B) A savings association must base all estimates of a property's value on an appraisal or evaluation of the property that satisfies 12 CFR part 564.

\* \* \* \* \*

l. Revise the first sentence of paragraph (i)(1)(iv) and paragraph (i)(4) of section 42 to read as follows:

**Section 42. Risk-Weighted Assets for Securitization Exposures**

\* \* \* \* \*

(i) \* \* \*

(1) \* \* \*

(iv) The savings association is well capitalized, as defined in the OTS's prompt corrective action regulation at 12 CFR part 565. \* \* \*

\* \* \* \* \*

(4) The risk-based capital ratios of the savings association must be calculated without regard to the capital treatment for transfers of small-business obligations with recourse specified in paragraph (i)(1) of this section as provided in 12 CFR 567.6(b)(5)(v).

\* \* \* \* \*

m. Revise paragraph (b)(3)(i) of section 52 to read as follows:

**Section 52. Simple Risk-Weight Approach (SRWA)**

\* \* \* \* \*

(b) \* \* \*

(3) \* \* \*

(i) *Community development equity exposures.* An equity exposure that is designed primarily to promote community welfare, including the welfare of low- and moderate-income communities or families, such as by providing services or jobs, excluding equity exposures to an unconsolidated small business investment company and equity exposures held through a consolidated small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682).

\* \* \* \* \*

n. Revise paragraph (c) in section 61 to read as follows:

**Section 61. Basic Indicator Approach**

\* \* \* \* \*

(c) *Annual gross income.* Annual gross income equals a savings association's net interest income (expense) before provision for losses on interest-bearing assets, plus total noninterest income, minus the portion of its other fees and charges that represents income derived from insurance and reinsurance

underwriting activities, minus (plus) its net income (loss) from the sale of assets held for sale and available-for-sale securities to include only the profit or loss from the disposition of available-for-sale securities pursuant to FASB Statement No. 115, minus (plus) its net income (loss) from the sale of securities held-to-maturity, all as reported on the savings association's year-end Thrift Financial Report.

\* \* \* \* \*

o. In section 71, revise paragraph (b) to read as follows:

**Section 71. Disclosure Requirements**

\* \* \* \* \*

(b) A savings association must comply with paragraph (c) of this section, unless it is a consolidated subsidiary of a bank holding company or depository institution that is subject to these requirements.

\* \* \* \* \*

Dated: July 2, 2008.

**John C. Dugan,**  
*Comptroller of the Currency.*

By order of the Board of Governors of the Federal Reserve System, July 10, 2008.

**Jennifer J. Johnson,**  
*Secretary of the Board.*

Dated at Washington, DC, this 25th day of June 2008.

By order of the Board of Directors, Federal Deposit Insurance Corporation.

**Robert E. Feldman,**  
*Executive Secretary.*

Dated: July 2, 2008.

By the Office of Thrift Supervision.

**John M. Reich,**  
*Director.*

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