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BANKING AND FINANCIAL REGULATION REPORT

# BASEL II: PROPOSED U.S. RULE IMPLEMENTING STANDARDIZED APPROACH

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On July 29, 2008, the federal banking agencies jointly issued for public comment a notice of proposed rulemaking (the "Proposed Rule") that would implement the "Standardized Approach" of Basel II for measuring and assessing the adequacy of risk-based capital. The Proposed Rule would replace the general risk-based capital rules currently in place for the vast majority of domestic bank and thrift organizations — the "non-core" organizations. Comments are due October 27, 2008.

With respect to any particular institution, the ultimate impact of the Proposed Rule, if finalized, will depend on the institution's mix of assets. A wider range of risk weights will apply. Generally, if favorable investment grade-ratings are available for commercial loans and similar assets, a banking organization may be able to reduce current capital charges. Unfavorable and below-grade ratings for these assets will mean higher charges, however. Capital charges for mortgage loan assets will depend significantly on loan-to-value ratios. Where these ratios are low, charges will be lower but, where they are high, the capital charges will increase. Also noteworthy are public disclosure requirements and an across-the-board change for all bank and thrift organizations: an operational risk charge, based on profits, that is in addition to risk-based capital charges for particular assets.

Several features of the Proposed Rule are likely to inspire comment, and the regulators have specifically invited comment on a number of points. Among the issues of broad interest are an increased reliance on external credit ratings, the possible use of the Proposed Rule by the largest U.S. banking organizations and a new set of deductions from Tier 1 capital.

## BACKGROUND

For close to two decades, bank and thrift organizations in the United States have been subject to risk-based capital rules, which require banking organizations to maintain capital against assets in a very rough proportion to the credit risk that those assets present. The rules, originated in 1988 with the Basel I Capital Accord ("Basel I"),[1] were developed by the Basel Committee on Banking Supervision (the "Basel Committee") to provide consistent capital rules, based on credit risk, for banking organizations throughout the world. Almost since inception, Basel I and the corresponding U.S. rules have been amended in response to various developments in the credit markets, such as the advent of securitizations. By the late 1990s, the Basel Committee acknowledged that the complexity of credit-related decisions by internationally active banking organizations had outstripped the capacity of Basel I to measure capital in a way that accounted sufficiently for credit risk.

[1] The formal title is "International Convergence of Capital Measurement and Capital Standards" and is available at http://www.bis.org/publ/bcbsc111.pdf?noframes=1. The concepts of Basel I are embedded in the current risk-based capital rules of the U.S. federal banking agencies, although these rules have been revised several times since 1988. *See* 12 C.F.R. part 3, App. A (national banks); 12 C.F.R. part 208, App. A (state member banks); 12 C.F.R. part 225, App. A (bank holding companies); 12 C.F.R. part 325, App. A (state nonmember banks); 12 C.F.R. part 567 (savings associations).

The Basel Committee accordingly began a lengthy analysis intended, in part, to enable banking organizations with sophisticated credit analysis tools to play a larger role in setting their own capital requirements. This work culminated in a revised framework for capital adequacy ("Basel II")[2] with three "pillars": (1) minimum capital requirements; (2) a supervisory process; and (3) market discipline through enhanced disclosure.[3] Within Pillar 1 are several options for determining capital requirements for credit and operational risks. For example, there is a Standardized Approach for measuring capital based on credit risk that is similar to the Basel I system, and is intended for banrking organizations without sophisticated credit analysis tools and that are not active internationally. There is also an Internal Ratings-Based Approach for sophisticated and internationally active organizations that allows such organizations to measure capital charges based on complex algorithms. Basel II also introduces the concept of a capital charge for "operational risk."[4] There are three different methodologies for calculating operational risk, including a Basic Indicator Approach and an Advanced Management Approach. Basel II leaves it to the national regulators and the banking organizations to adopt the most appropriate option based on financial market infrastructure and the operations of the banking organizations.

In December 2007, after a lengthy period of public discussion, including Congressional hearings, the U.S. banking agencies issued a final rule implementing Basel II for the largest internationally active institutions, known as "core" banking organizations[5] (the "Advanced Approach"). The Advanced Approach is mandatory for these core organizations and voluntary for all other — "non-core" — banking organizations, so long as those organizations seeking to opt in meet certain stringent criteria. There currently are approximately 12 core banking organizations in the United States. Given the complexity of the Advanced Approach and the internal costs necessary for its implementation, only a handful of the very largest non-core banking organizations are likely to elect the Advanced Approach. The Advanced Approach does *not* adopt Basel II in its entirety. Rather, only the most complex risk-measuring elements are made available to core banking organizations (and others that may opt in). Thus, a core banking organization must use only the Internal Ratings-Based Approach (and its complex algorithms) in measuring capital based on credit risk and must use the Advanced Management Approach for operational risk. Banking organizations not subject to the

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[2] The operative Basel II document is "International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Comprehensive Version)" (June 2006). This document is available at http://www.bis.org/publ/bcbs128.pdf?noframes=1. Two earlier versions also are available, one dated June 2004 and the other November 2005.

[3] Basel I, by contrast, is essentially a single-pillar regime, dealing only with minimum capital requirements. U.S. banking organizations all have been effectively subject to the other pillars — active supervision and disclosure requirements — for several decades.

[4] Basel II defines operational risk as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk." Basel II, part V.A.644.

[5] Core banking organizations under the Proposed Rule are those that (i) have consolidated total assets of $250 billion or more; (ii) have consolidated total on-balance sheet exposures of $10 billion or more; (iii) are a subsidiary of a depository institution subject to the Advanced Approach; or (iv) are a subsidiary of a bank holding company subject to the Advanced Approach.

Advanced Approach would, by default, continue use of the existing Basel I general risk-based capital rules.

Even before the Advanced Approach was finalized, non-core organizations still subject to the general risk-based capital rules had voiced considerable concern that a bifurcated risk-based capital system in the United States would introduce domestic competitive inequalities — as Basel II seeks to avoid internationally. The Basel II Internal Ratings-Based Approach is expected, for example, to result in materially lower capital requirements for many types of mortgage-related assets. To address these concerns, the agencies proposed a so-called "Basel IA" approach in December of 2006,[6] which might best be described as a Basel I/Basel II hybrid. In response, many commenters urged the regulators simply to adopt Basel II's Standardized Approach for credit risk-related measurements. The Proposed Rule is the agencies' attempt to do so. Basel IA has been abandoned.

**OVERVIEW OF THE PROPOSED RULE**

The Proposed Rule generally adopts Basel II's Standardized Approach for credit risk and the Basic Indicator Approach (BIA) for operational risk (together, the "Standardized Approach"). The major differences between the current rules — referred to in the Proposed Rule and herein as the "general risk-based capital rules" — and the Standardized Approach of the Proposed Rule relate primarily to risk-based capital requirements. Specifically, the Standardized Approach:

1. increases the number of risk weights from five to 16 (0 percent to 1250 percent) and provides for different risk weights within the same asset category;
2. provides for the expanded use of external credit ratings;
3. provides for the expanded use of collateral, guaranties and other risk mitigants;
4. requires a capital charge for operational risk.

Additionally, the Proposed Rule, in implementing Pillar 2 of Basel II, provides incentives for banking organizations to develop and apply better techniques for assessing and managing risk and ensuring capital adequacy to support risk. With respect to Pillar 3, the Proposed Rule imposes public disclosure requirements that are in addition to the periodic and other reporting requirements for publicly traded institutions, and to quarterly call reports.

The Proposed Rule is not mandatory. Adoption of the Standardized Approach would be optional for all non-core banking organizations. Indeed, the U.S. agencies are seeking comment as to whether the Standardized Approach should also be optional for core banking organizations. If a banking organization chooses to comply with the Standardized Approach, this approach must, subject to certain limited exceptions, be used by the parent holding company as well as all depository institution subsidiaries within a

[6] *See* 71 Fed. Reg. 77446 (Dec. 26, 2006).

corporate family. The purpose of this requirement is to protect against regulatory arbitrage. (The Proposed Rule requests comment on this all-or-nothing feature, however.) The Proposed Rule also provides a mechanism for a banking organization that has elected the Standardized Approach to opt out. The agencies do, however, reserve the right to require a non-core banking organization to use the Standardized Approach and the right to require a non-core banking organization using the Standardized Approach to discontinue such use.

The agencies are seeking comment on all aspects of the Proposed Rule, and are particularly interested in comments relating to the extensive use of external credit ratings to determine risk weights in light of recent market events.

## PILLAR 1 – CAPITAL CALCULATIONS AND NEW RISK-WEIGHTED CAPITAL CHARGES

The Proposed Rule retains the minimum Tier 1 risk-based capital ratio and the minimum total risk-based capital ratio set forth in the general risk-based capital rules. A banking organization's risk-based capital requirement continues to be calculated by dividing the sum of its qualifying (Tier 1 and Tier 2) capital by its total risk-weighted assets.

### A. Capital Calculations

The Tier 1 and Tier 2 capital elements – common stock, preferred stock, subordinated debt, etc. – remain essentially the same under the Proposed Rule. The agencies have, however, tinkered with required deductions with the result that, in the end, Tier 1 capital is calculated differently under the Proposed Rule. In particular, banking organizations would now deduct from Tier 1 capital any after-tax gain on sale resulting from a securitization. Banking organizations would also be required to deduct 50/50 from Tier 1 and Tier 2 capital (i) any credit-enhancing, interest-only instruments (CEIOs) not constituting after-tax gain on sale; (ii) certain securitization exposures; and (iii) certain unsettled transactions. Several current deductions no longer would be required: (i) certain CEIOs deductions; (ii) deductions of bank and bank holding company investments in certain nonfinancial equities; and (iii) deductions of savings association investments in equity securities that are not equity investments in real estate.

Under the Proposed Rule, a banking organization's total risk-weighted assets are the sum of its total risk-weighted assets for its general credit risk, unsettled transactions, securitization exposures, equity exposures and operational risk. Banking organizations subject to the market risk rule (MRR) are required to factor these provisions into their capital calculations.

The Proposed Rule does not eliminate or otherwise alter the Tier 1 leverage ratio (Tier 1 capital/average total consolidated assets). However, given potential for three different definitions of Tier 1 capital under the Advanced Approach, Standardized Approach and general risk-based capital rules, the agencies are seeking comment on all aspects of the

Tier 1 leverage ratio numerator, particularly comments relating to regulatory burden and competitive equality.

## B. Exposure Calculation

### 1. On-Balance Sheet Exposures.

Consistent with the general risk-based capital rules, the exposure amount for an on-balance sheet asset is generally the carrying value. However, as further discussed below, the Proposed Rule provides specific processes for the determination of exposure amounts for on-balance sheet OTC derivative contracts, repo-style transactions, eligible margin loans and securitizations.

### 2. Off-Balance Sheet Exposures.

Consistent with the general risk-based capital rules, off-balance sheet exposures must be converted to on-balance sheet equivalents using the appropriate designated credit conversion factor (CCF) for that exposure. This is accomplished by multiplying the notional or maximum amount of the exposure by the applicable CCF set forth in the Proposed Rule. The CCFs range from zero to 100 percent and remain unchanged from the general risk-based capital rules except with respect to the following: (i) The CCF for short-term commitments that are not unconditionally cancelable is raised from zero to 20 percent; (ii) the CCF for short-term self-liquidating trade-related contingent items arising from the movement of goods is raised from 10 to 20 percent; and (iii) the CCF for off-balance sheet securities financing transactions is raised from zero to 100 percent. These increases are intended to better reflect the risk associated with these off-balance sheet exposures.

## C. Use of External and Inferred Ratings

The general risk-based capital rules provide for limited use of external ratings. Specifically, the use of external ratings is limited to recourse obligations, direct credit substitutes, residual interests (other than CEIOs) and securitizations. The Proposed Rule expands the use of external ratings to sovereigns, public sector entities (PSEs) and corporate exposures that have external ratings. The Proposed Rule also requires the use of solicited ratings, as opposed to unsolicited ratings, but seeks comment on this point.

The general risk-based capital rules limit the use of inferred ratings to securitization structures. The Proposed Rule expands the use of inferred ratings to permit banking organizations to infer ratings on exposures to sovereigns and PSEs and on unrated corporate exposures from either (i) the issuer rating of the obligor; or (ii) the external rating of another exposure of the obligor. As noted above, the agencies are seeking comment as to the advantages and disadvantages with respect to the use of ratings and whether, based on the recent demonstration of weaknesses in the credit rating process, changes are warranted to the Standardized Approach. The agencies emphasize in the

preamble to the Proposed Rule that the use of external ratings does not alleviate a banking organization's responsibility to conduct its own due diligence on risk exposure.

## D. General Credit Risk

In order to calculate total risk-weighted assets for general credit risk, a banking organization must first determine the exposure amount of each of the following assets: (i) on-balance sheet assets; (ii) OTC derivative contracts; (iii) off-balance sheet commitments; (iv) trade and transaction-related contingencies; (v) guarantees; (vi) repurchase agreements; (vii) securities lending and borrowing transactions; (viii) financial standby letters of credit; (ix) forward agreements; and (x) any similar transactions that are not unsettled transactions, securitization exposures or equity exposures. Each individual exposure is then multiplied by its appropriate risk weight as determined based on the obligor or exposure type and the presence of any eligible guarantors or eligible financial collateral. The risk-weighted assets for each exposure are then totaled to obtain the total risk-weighted assets for general credit risk.

### 1. External Ratings.

The Proposed Rule expands the use of external ratings to sovereigns, PSEs and corporate exposures with external ratings. In order to use an external rating to determine the risk weight of an exposure to a sovereign, PSE or corporate exposure, the credit rating must (i) be issued by an nationally recognized statistical rating organization (NRSRO); (ii) fully reflect the entire amount of the credit risk with respect to all payments owed to the holder of the exposure;[7] and (iii) be publishable in an accessible format and be included in the transition matrices, made publicly available by the NRSRO, that summarize the historical performance of positions rated by the NRSRO. Ratings may be solicited or unsolicited by the obligor. Where an exposure has a single external rating, that rating is the applicable rating. Where an exposure has multiple ratings, the lowest rating must be used.

### 2. Inferred Ratings.

The Proposed Rule expands the use of inferred ratings to permit banking organizations to infer ratings on exposures to sovereigns and PSEs and on unrated corporate exposures from either: (i) the issuer rating of the obligor; or (ii) the external rating of another exposure of the obligor. Where an unrated exposure has only one inferred rating, that rating would be the applicable rating. Where there are multiple inferred ratings, the applicable rating would be the lowest rating.

In order to infer a rating based on an *issuer* rating, the banking organization's unrated exposure must be a senior exposure (i.e., it ranks at least equal to the issuer's general creditors) and the issuer rating must be (i) assigned by an NRSRO; (ii) reflect the issuer's

[7] This means that the exposure is in the NRSRO's monitoring/surveillance program, which requires a periodic review of the financial performance of the underlying exposure, thereby ensuring the credit rating fully reflects the entire amount of the credit risk.

capacity and willingness to satisfy all of its financial obligations; and (iii) be publishable in an accessible format and be included in the transition matrices made publicly available by the NRSRO.

In order to infer a rating based on the external rating of *another exposure* issued by the same obligor and secured by the same collateral (if any), that rating: (i) must rank equal or subordinate in all respects to the unrated exposure; (ii) must have a long-term rating; (iii) must not benefit from any credit enhancement unavailable to the unrated exposure; (iv) must have an effective maturity date equal to or longer than the unrated exposure; and (v) must, subject to certain limited exceptions, be denominated in the same currency as the unrated exposure.

3. Risk-Weighted Assets for General Credit Exposures.

The Proposed Rule groups general credit exposures into the following 11 categories: (i) sovereign entities; (ii) supranational entities and multilateral development banks (MDBs); (iii) PSEs; (iv) depository institutions, foreign banks and credit unions; (v) corporate; (vi) regulatory retail; (vii) residential mortgage; (viii) pre-sold construction loans; (ix) statutory multifamily mortgage; (x) past due and nonaccrual exposures; and (xi) other assets. The process for determining risk-weighted assets for each category is set forth below.

*Sovereign Entities.*

The general risk-based capital rules assign risk weights to a sovereign exposure based on the type of exposure and the sovereign's membership status in the Organization for Economic Cooperation and Development (OECD). As noted above, the Proposed Rule assigns risk weights to sovereign[8] exposures based on the exposure's applicable external or inferred rating. As set forth in the table below, taken from the Proposed Rule, risk weights range from zero to 150 percent. Where there is no applicable rating, a 100 percent risk weight is used.

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 | CCC | 150 |

[8] Under the Proposed Rule, a sovereign entity is a central government or any agency, department ministry or central bank of a central government. A sovereign is not a state or local government.

| investment grade | | |
|---|---|---|
| No applicable rating | N/A | 100 |

To calculate the risk-weighted amount for a sovereign exposure, the exposure amount is multiplied by the risk weight assigned to the exposure's external or inferred rating. A lower risk weight may be applied under certain circumstances.[9]

*Supranational Entities and Multilateral Development Banks.*

The Proposed Rule assigns a zero percent risk weight to supranational entities, including the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund and the MDBs specified in the rule.[10]

*Public Sector Entities.*

The general risk-based capital rules assign risk weights of 20, 50 or 100 percent based on the exposure type and the OECD membership status of the PSE's sovereign of incorporation. Under the Proposed Rule, the risk weights for domestic and foreign PSE[11] exposures are based on the applicable external or applicable inferred long-term rating.[12] As set forth in the table below, taken from the Proposed Rule, risk weights range from 20 to 150 percent. A 50 percent risk weight is required for PSE exposures with no applicable external or applicable inferred long-term rating.[13]

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 |

[9] A lower risk weight may be assigned if (i) the exposure is denominated in the sovereign entity's currency; (ii) the banking organization has at least an equivalent amount of liabilities in that currency; and (iii) the sovereign entity allows banking organizations under its jurisdiction to assign the lower risk weight to the same exposures to the sovereign entity.

[10] The MDBs that qualify under the Proposed Rule for a zero risk weight are the International Bank for Reconstruction and Development, the International Finance Corporation, the Inter-American 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 that the U.S. government is a shareholder or contributing member of, or which the applicable federal banking agency determines poses comparable credit risk.

[11] A PSE is defined under the Proposed Rule to include a domestic or foreign state, local authority or other governmental subdivision below the level of a sovereign entity.

[12] Short-term ratings also may be a basis for assigning risk weights, a point on which comment is requested.

[13] The risk weights in the table below are different from the risk weights for depository institution exposures immediately below. The Proposed Rules requests common on whether the risk weights for the two categories should be the same and, if so, which table should be used.

| 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 |

To calculate the risk-based amount of a PSE exposure, the nominal exposure is multiplied by the risk weight assigned to the exposure's external or inferred rating. Lower risk weights may be assigned to foreign PSEs under certain circumstances.[14] However, a PSE exposure with no external rating may not receive a risk weight that is lower than the risk weight corresponding to the lowest issuer rating of the PSE's sovereign of incorporation.

*Depository Institutions, Foreign Banks and Credit Unions.*

The general risk-based capital rules risk-weight exposures to depository institutions, foreign banks and credit unions based on the OECD membership status of the institution's sovereign of incorporation. Under the Proposed Rule, the risk weight is based on the external rating of the institution's sovereign of incorporation — specifically, the lowest issuer rating of the sovereign. As set forth in the table below, taken from the Proposed Rule, risk weights range from 20 to 150 percent. Generally, these risk weights are one category higher than the risk weight assigned to an exposure of the applicable sovereign. A 100 percent risk weight is required where the applicable sovereign does not have an issuer rating.

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 |

[14] A lower risk weight may be assigned to a foreign PSE if: (i) the PSE's sovereign of incorporation allows banks under its jurisdiction to assign the lower risk weight; and (ii) the risk weight is not lower than the risk weight that corresponds to the lowest issuer rating of the PSE's sovereign of incorporation.

Under the Proposed Rule, the risk-based amount of an exposure to these institutions is calculated by multiplying the exposure amount by the risk weight assigned to the lowest issuer rating of the entity's sovereign of incorporation. A 100 percent risk weight is required for an exposure included in the regulatory capital of a depository institution or foreign bank and that is not subject to deduction as a reciprocal holding.

*Corporate.*

The general risk-based capital rules risk weight most corporate exposures at 100 percent. Under the Proposed Rule, the risk weight is based on the external rating of the exposure. The Proposed Rule permits a banking organization to choose one of two different methods to risk-weight corporate exposures[15] — a 100 percent risk-weight approach or a ratings-based approach. Under the 100 percent risk-weight approach, a banking organization must risk-weight all corporate exposures at 100 percent, regardless of external ratings. Under the ratings-based approach, subject to certain limited exceptions, a corporate exposure must be risk-weighted based on its applicable external or applicable inferred rating based on a long-term rating, or its applicable external rating based on a short-term rating. As set forth in the table below, taken from the Proposed Rule, risk weights range between 20 and 150 percent, with a required 100 percent risk weight where there is no applicable rating.[16]

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 |

[15] Under the Proposed Rule, a corporate exposure is one 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 (i) an exposure to a sovereign entity, a designated supranational entity, a designated MDB, a depository institution, a foreign bank, a credit union or a PSE; (ii) a regulatory retail exposure; (iii) a residential mortgage exposure; (iv) a pre-sold construction loan; (v) a statutory multifamily mortgage; (vi) a securitization exposure; or (vii) an equity exposure.

[16] As an aside, we would note that events already have overtaken one issue in the Proposed Rule. The agencies requested comment on whether "financial strength" ratings should be used to determine risk weights for GSE exposures. Given the recent conservatorships of Fannie Mae and Freddie Mac, this point is probably moot.

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 |

Upon determination of the applicable risk weight, risk-weighted amounts of corporate exposures are then calculated by multiplying the nominal exposure amounts by the applicable risk weight.

*Regulatory Retail.*

The general risk-based capital rules assign a 100 percent risk weight to exposures that would be defined under the Proposed Rule as regulatory retail exposures. The Proposed Rule assigns a 75 percent risk weight to these exposures. Regulatory retail exposures are those that meet three criteria: (i) The 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 does not qualify as any other general credit exposure, a securitization exposure, an equity exposure or a debt security. Examples include credit cards, auto loans and revolving lines of credit. Retail exposures not meeting these requirements are treated as corporate exposures — and by default would be risk-weighted at 100 percent. The risk-weighted amount of a regulatory retail exposure is calculated by simply multiplying the exposure amount by 75 percent.

The Proposed Rule does not include any concentration limits for these retail exposures. The agencies observe, however, that Basel II suggests a 20 basis point limit on aggregate exposure to a single obligor — i.e., a single obligor's retail obligations should not constitute more than 20 basis points of an institution's assets. The agencies request comment on whether this — or any other limit — should be built into the risk-weighting process for regulatory retail exposures.

*Residential Mortgage.*

The general risk-based capital rules risk weight residential mortgage exposures at 50 or 100 percent depending on the lien position and whether the exposure meets certain prudential underwriting criteria. Under the Proposed Rule, residential mortgage exposures are risk-weighted depending on lien position and the loan-to-value ratio ("LTV ratio"). The Proposed Rule also requires banking organizations to hold capital for both the funded and unfunded portions of such exposures. To obtain the risk-weighted amount

of a residential mortgage exposure, the funded and unfunded exposures are multiplied by their respective risk weights and then added together.[17]

Under the Proposed Rule, a residential mortgage exposure is an exposure secured by a one-to-four family residential property. Residential mortgage exposures are categorized either as first-lien exposures or as junior-lien exposures, and a different method for calculating risk-weighted amounts is provided for each.

A first lien exposure is one that is secured by a first lien or a first and a junior lien where no other party holds an intervening lien. First-lien exposures that are (i) secured by owner-occupied or rental property, (ii) prudently underwritten, (iii) not 90 days or more past due and (iv) not on nonaccrual are assigned risk-weights from 20 to 150 percent based on the LTV ratio as provided in the table below, as taken from the Proposed Rule.

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 |

First-lien exposures that do not meet each of the stated criteria are assigned risk-weights of 100 or 150 percent based on the LTV ratio. A first-lien exposure not meeting the stated criteria that is later restructured to meet the criteria may be assigned a risk weight lower than 100 percent if the LTV ratio is updated at the time of the restructure and is based on a current appraisal.

A junior-lien exposure is one that is not a first-lien exposure. The LTV ratio for junior-lien exposures that are not 90 days or more past due or on nonaccural is calculated based on the junior-lien loan amount and all senior exposures. As provided in the table set forth below, taken from the Proposed Rule, a risk weight of 75, 100 or 150 percent is then assigned to the exposure based on the LTV ratio.

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 |

[17] The funded exposure amount is the carrying value. Because the unfunded portion of the exposure is an off-balance sheet asset, the unfunded amount is the notional amount multiplied by the appropriate CCF.

| Greater than 60 and less than or equal to 90 | 100 |
|---|---|
| Greater than 90 | 150 |

Junior-lien exposures that are 90 days or more past due or on nonaccrual are risk-weighted at 150 percent.

The LTV ratio is the loan amount divided by the value of the property. The value of the property is the lesser of the acquisition cost and the appraised value.[18] The LTV ratio must be calculated for any funded and unfunded portion of the loan.

The loan amount for the funded portion of a first lien exposure is the outstanding principal amount. The loan amount for the funded portion of a junior lien exposure is the principal amount of the exposure plus the principal amount of all senior liens (as of the date the junior lien exposure was originated) plus any unfunded portion of the maximum contractual amount of all senior liens. The unfunded portion for both first and junior lien exposures is the funded portion of that exposure plus the unfunded portion of the maximum contractual amount of the exposure.

The loan amount in the numerator of the LTV ratio may be reduced to reflect the value of any loan-level private mortgage insurance. To qualify, loan-level[19] private mortgage insurance must be provided by a regulated insurance company that is not an affiliate of the banking organization and that (i) 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; and (ii) has a claims-paying rating that is in at least the third-highest investment grade rating category. Given the relative importance of LTV calculations and the potential importance of private mortgage insurance, the agencies expressly request comment on these aspects of risk-weighting residential mortgages. The agencies also invite comment on alternative methods of segmenting the risk weights for different mortgage loans.

*Pre-Sold Construction Loans and Statutory Multifamily Mortgages.*

A pre-sold construction loan is defined under the Proposed Rule as a loan to a residential builder for one-to-four family residential property construction that otherwise meets the requirements of section 618(a)(1) or (2) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 (RTCRRIA) and the applicable agency implementing regulations. Under the Proposed Rule, a pre-sold construction loan is subject to a 50 percent risk weight unless the purchase contract is cancelled. Pre-sold construction loans with cancelled purchase contracts are risk-weighted at 100 percent under the provision addressing "other assets." This methodology is consistent with the RTCRRIA and the current risk-based capital rules.

[18] The appraisal must satisfy regulatory criteria.
[19] The agencies have not provided for the use of pool-level private mortgage insurance because its structure does not facilitate the determination of an LTV ratio for a mortgage loan.

A statutory multifamily mortgage is defined under the Proposed Rule as a multifamily residential mortgage that meets the requirements of section 618(b)(1) of the RTCRRIA and the applicable agency implementing regulations. A statutory multifamily mortgage would be subject to a 50 percent risk weight. Multifamily mortgages that do not meet the definition of statutory multifamily mortgage are risk-weighted at 100 percent under the provision addressing "other assets." This approach, too, is consistent with the RTCRRIA and the general risk-based capital rules.

*Past Due Loans.*

The general risk-based capital rules do not generally distinguish between current and past due loans. Under the Proposed Rule, past due loans (those more than 90 days past due or on nonaccrual), other than past due residential mortgages, are risk-weighted at 150 percent for that portion of the exposure that is unsecured or not guaranteed. Risk weights may be assigned to collateralized or guaranteed portions of the exposure based on the relevant credit risk mitigation provisions of the Proposed Rule as further discussed below. The Proposed Rule includes no mechanism for adjusting the amount or risk weight of a past due loan if a banking organization has made a specific provision for it, but the agencies have requested comment on this issue.

*Other Assets.*

With respect to the following assets, the Proposed Rule generally mirrors the existing current risk-based capital rules:

- A zero percent risk weight is assigned to
  - cash owned and held in all offices or in transit;
  - gold bullion in the banking organization's own vaults or held in another depository institution's vaults on an allocated basis, to the extent gold bullions are offset by gold bullion liabilities; and
  - derivative contracts publicly traded on an exchange that requires the daily receipt and payment of cash-variation margins;
- A 20 percent risk weight to cash items in the process of collection; and
- A 100 percent risk weight to all other assets (other than those deducted from Tier 1 and Tier 2 capital) not assigned a risk weight under the Proposed Rule.

4. <u>OTC Derivative Contracts</u>.

The exposure amount for OTC derivative contracts is based on the sum of the "current exposure" (a measure of what would be owed to the banking organization if the contracts were terminated on the calculation date) and the "potential future exposure" or PFE (a measure of the additional exposure to which the banking organization might be subject due to market movements over time). As further discussed below, the method for determining the exposure amount for contracts subject to a qualifying bilateral master

netting contract ("Netting Contract") is modified somewhat to enable banking organizations to recognize the risk reduction benefits from netting multiple positions.

*OTC Derivative Contracts Not Subject to a Netting Contract.*

The exposure amount for contracts not subject to a Netting Contract is determined on a contract-by-contract basis, then aggregated over all contracts in this category. For each contract, the current exposure is the mark-to-market value of the contract, if positive.[20] Any negative mark-to-market value is considered to be zero for purposes of the calculation. The PFE is the product of the notional amount of the contract and a conversion factor based on the type and duration of the derivative contract. The conversion factors are included in a table in the Proposed Rule.

*OTC Derivative Contracts Subject to a Netting Contract.*

A single exposure amount is determined for all derivatives contracts which are subject to a Netting Contract, and the results are then added over all Netting Contracts. For each group of netted contracts, the current exposure is determined by aggregating the mark-to-market values (whether positive or negative) of all contracts in the category. This aggregation permits the banking organization to reduce its capital requirement where the organization has a positive mark-to-market value on some contracts and the counterparty has a positive mark-to-market value on others. If the result of the aggregation is a positive number, that number is the current exposure. If the result is negative or zero, the current exposure is set at zero.

Calculation of the PFE for the group of contracts subject to a single Netting Contract is generally lower than the simple sum of the PFE for all contracts in the group. A gross PFE is first determined by aggregating the PFEs determined for each contract as if the contract were not subject to a Netting Contract. The extent to which that sum will be reduced as a result of the Netting Contract is then identified by calculating the ratio (the "Netting Ratio") between the current exposure on a net basis (as determined in the prior paragraph) and the current exposure which would have been applied if the contracts were not subject to a Netting Contract. The future exposure for the group of contracts is equal to a weighted sum of the gross PFE (with a 40 percent weight) and the Netting Ratio times the gross PFE (with a 60 percent weight). If the Netting Ratio is zero, only 40 percent of the gross PFE will contribute to the capital requirement. With a 20 percent Netting Ratio, 52 percent of the gross PFE will contribute.

A Netting Contract qualifies for the beneficial treatment described in the prior two paragraphs if it meets all of the following criteria: (i) It creates a single legal obligation for all contracts upon counterparty default (including bankruptcy); (ii) it allows the banking organization to accelerate, close-out contracts on a net basis, and liquidate or set-

[20] The mark-to-market value would be positive if the counterparty on the contract would owe the banking organization upon termination of the contract and would be negative if the banking organization would owe the counterparty upon termination of the contract.

off against collateral held upon counterparty default (including bankruptcy) without the banking organization's contractual rights being subject to a stay; (iii) the banking organization has undertaken sufficient legal review to determine that its close-out and liquidation rights are enforceable; (iv) the banking organization has procedures to monitor legal developments which might affect the status of the agreement as a Netting Contract; and (v) the contract does not contain a walkaway clause.[21]

*Credit Derivatives.*

If a banking organization has purchased protection through a credit derivative which would be considered a credit risk mitigant for an exposure that is not a covered position under the MRR, then the banking organization is not required to determine a risk-weighted capital requirement for that credit derivative (as long as the banking organization does the same for all similarly situated credit derivatives, and either includes all or excludes all credit derivatives which are covered by a single Netting Contract in determining the exposure amount). Where the banking organization is providing protection through a credit derivative, it should determine its exposure with respect to the credit derivative's reference obligor, rather than the counterparty who has purchased credit protection (as long as the banking organization does the same for all similarly situated credit derivatives, and either includes all or excludes all credit derivatives which are covered by a single Netting Contract in determining the exposure amount). If the credit derivative is considered a covered position under the MRR, the banking organization must also determine its exposure with respect to the counterparty.

*Equity Derivatives.*

For purposes of determining risked-based capital under the Proposed Rule, equity derivatives are treated as equity exposure (unless the banking organization considers the equity derivative to be a covered position under the MRR). For an equity derivative that is treated as a covered position under the MRR, the banking organization must also determine counterparty credit exposure. Risk-based capital need not be held with respect to the counterparty credit risk of an equity derivative contract if the simple risk-weight approach described below is used to calculate the risk-weighted amount for the contract, as long as all equity derivatives are given similar treatment and equity derivative contracts under a Netting Contract are either all included or all excluded in determining the counterparty exposure amount.

*Risk Weights.*

The risk weight applied to the exposure amount of an OTC derivative contract under the Proposed Rule is the risk weight for the counterparty or, where applicable, the risk weight associated with collateral or the guarantor. The general risk-based capital rules capped the risk weight for OTC derivatives at 50 percent in recognition of the high quality of participants in the derivatives market at the time those rules were adopted. In light of the

[21] A walkaway clause provides that if calculation of the termination value under a contract results in an amount to be paid by the non-defaulting party, that party need not make any payment.

changes in the type and quality of market participants, however, the Proposed Rule removes the 50 percent cap on the risk weight and applies the risk weight that would be applied in connection with any other type of exposure.

5. Risk Mitigants.

*Guarantees and Credit Derivatives.*

The Proposed Rule expands the ability of a banking organization to reduce the risk-weighted amount of an exposure based on an eligible guarantee or an eligible credit derivative. Using a substitution approach, the Proposed Rule permits, under certain circumstances, an eligible guarantee or an eligible credit derivative to be substituted for the amount of an exposure. Generally, if the amount of protection provided by a guarantee or credit derivative is greater than or equal to the amount of an exposure, the risk weight applicable to the guarantee or credit derivative may be substituted for that applicable to the exposure. If the protection amount is less than the exposure amount, the banking organization may treat the protected and unprotected amounts as two separate exposures and, with respect to the protected amount, substitute the risk weight applicable to the guarantee or credit derivative. The amount of any protection must be adjusted to reflect any maturity mismatch, lack of restructuring coverage or currency mismatch.

Eligible guarantors under the general risk-based capital rules include only central governments, GSEs, PSEs in OECD countries, multilateral lending institutions and regional development banks, U.S. depository institutions, foreign banks and qualifying securities firms in OECD countries. Under the Proposed Rule, "eligible" guarantors would include any sovereign entity, certain supranational entities, certain MDBs, a Federal Home Loan Bank, Farmer Mac, depository institutions, foreign banks, credit unions, bank holding companies, savings and loan holding companies, and any other entity (other than a securitization special purpose entity) that has issued unsecured debt without credit enhancement that has a long-term external rating. To be eligible, guarantees must meet the following criteria:

- be in writing;
- be unconditional;
- cover all or a pro rata portion of all contractual payments of the obligor;
- provide the beneficiary with a direct claim against the protection provider;
- not be unilaterally cancellable by the protection provider other than for breach of contract by beneficiary;
- be legally enforceable against the protection provider;
- requires protection provider to make payments to beneficiary on the occurrence of default in a timely manner without the beneficiary first having to take legal action against the obligor;
- not increase the beneficiary's cost of credit protection of the guarantee in response to deterioration in the credit quality of the exposure; and

- not be provided by an affiliate unless the affiliate is an insured depository institution, foreign bank, securities broker or dealer, or an insurance company that does not control the bank and is subject to consolidated supervision.

Under the Proposed Rule, eligible credit derivatives include credit default swaps, $n^{th}$-to-default swaps, total return swaps or any other forms approved by the primary federal regulator. To be "eligible," credit derivatives must meet all the requirements of eligible guarantees plus these additional requirements:

- Both parties to the contract must have confirmed the contract, and upon assignment of the contract all relevant parties must have confirmed the assignment;
- The contract must specify the settlement terms;
- For a cash-settled contract, the method for determining the loss amount must be robust and reliable;
- For a physically settled contract, if consent is required for delivery of the reference obligations, then, for at least one reference obligation, the contract must provide that consent may not be unreasonably withheld;
- For credit default swaps and $n^{th}$-to-default swaps,
    - the trigger events must include payment default (with market standard thresholds and cure periods consistent with the reference obligations) and insolvency; and
    - the contract must clearly identify who determines whether a trigger event has occurred (the banking organization as buyer of protection must have at least some say in that determination and must have the right to notify the provider of protection that a trigger event has occurred); and
- For total return swaps, if the banking organization records net payments under the swap as net income, it must also record any reduction in the value of the exposure being hedged by the swap.

*Collateral.*

The Proposed Rule provides for the expanded ability to reduce the risk-weighted amount of an exposure based on financial collateral. Financial collateral includes cash on deposit, gold bullion, long-term debt securities with an applicable external rating one category below investment grade or better, short-term debt securities with an applicable external rating of at least investment grade, equity securities that are publicly traded, convertible bonds that are publicly traded, money market mutual fund shares and other mutual fund shares if a price for the shares is publicly quoted daily, and conforming[22] residential mortgage exposures. Banking organizations may recognize financial collateral by choosing one of the following three approaches, so long as the same approach is used for all similar exposures: (i) the Simple Approach; (ii) the Collateral

[22] Conforming residential mortgage loans are those that meet Fannie Mae and Freddie Mac standards.

Haircut Approach; or (iii) the Simple VaR Approach. The Collateral Haircut Approach and the Simple VaR Approach are the same as that available for core banks under the Advanced Approach.

The Simple Approach may be used (i) for any type of exposure secured by financial collateral or (ii) for repo-style transactions that are included in the banking organization's value-at-risk or VaR-based measure under the MRR and secured by any type of collateral, so long as the following requirements are met:

- the collateral is subject to a collateral agreement for at least the life of the exposure;
- the collateral is revalued every six months; and
- the collateral (other than gold) and the exposure must be denominated in the same currency.

Under the Simple Approach, the risk weight of the collateral would be substituted for the risk weight of the exposure for that portion of the exposure covered by collateral. Under this approach, with certain exceptions, the risk weight generally will not be less than 20 percent. The risk weight for the unsecured portion must be the risk weight assigned to the exposure itself.

The Collateral Haircut Approach may be used where financial collateral secures a repo-style transaction, eligible margin loan,[23] collateralized OTC derivative contract,[24] or single-product netting set of such transactions and where any type of collateral secures a repo-style transaction that is included in the banking organization's VaR-based measure under the MRR. Under this approach, the exposure amount is adjusted by (i) a reduction to account for the collateral value, (ii) an increase to account for the market volatility in the value of the collateral and (iii) an increase to reflect the currency risk for any collateral denominated in a currency which is different from the settlement currency of the transaction being collateralized. In determining the increases related to market volatility and currency risk, a banking organization may use the standard supervisory haircuts set forth in tabular format in the Proposed Rule or, with regulatory approval, haircuts based on its own internal models. The reduced exposure amount would then be multiplied by the risk weight appropriate for an unsecured claim on the counterparty.

[23] The Proposed Rule defines "eligible margin loans" as extensions of credit where (i) the extension of credit is collateralized 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 providing the banking organization with the right to accelerate and terminate the extension of credit and to liquidate or set off collateral promptly upon an event of default and that any exercise of these right will not be stayed or avoided under applicable law in the relevant jurisdictions; and (iv) the banking organization's legal review was thorough and sufficient to conclude the agreement meets the requirements of (iii) above and is legal, valid, binding and enforceable under applicable law.

[24] The Collateral Haircut Approach is only available for OTC derivatives if the collateral is marked-to-market on a daily basis and collateral posted is adjusted on a daily basis.

Upon written supervisory approval, the Simple VaR Approach may generally be used for single-product netting sets of repo-style transactions and eligible margin loans that are subject to a qualifying master netting agreement. The exposure amount would be the carrying value of the exposure less the value of the collateral plus a VaR-based estimate of the PFE. The PFE would be the maximum exposure expected to occur on a future date with a high level of confidence. The VaR model must meet certain criteria and would be subject to regular backtesting. The risk weight would be that appropriate for an unsecured claim on the counterparty.

### E. Unsettled Transactions

The Proposed Rule provides for a more risk-sensitive risk-based capital treatment for unsettled and failed transactions, foreign exchange and commodities transactions that have a risk of delayed settlement or delivery. The Proposed Rule treats separately delivery-versus-payment (DvP) transactions with a normal settlement period and payment-versus-payment (PvP) transactions with a normal settlement period. Risk-based capital would be required to be held against each if the counterparty has not made delivery or payment within five business days after the settlement date. The exposure amount is the positive current exposure or the difference between the transaction value at the agreed settlement price and the current market price if the difference results in a credit exposure to the counterparty. The appropriate risk weight would range from 100 percent to 1250 percent based on the number of days after the contractual settlement date the transaction is delayed. The capital requirement would not apply to certain types of transactions, including transactions accepted by a qualifying central counterparty that are subject to daily marking-to-market and daily receipt and payment of variation margin, repo-style transactions, one-way cash payments on OTC derivative contracts and transactions with a contractual settlement period that is longer than the normal settlement period.

For non-DvP and non-PvP transactions with a normal settlement period, risk-based capital would be required if cash, securities, commodities or currencies have been delivered to the counterparty and the corresponding deliverables have not been received by the end of the business day. The exposure is the current market value of the deliverables and the appropriate risk weight is that applicable to the exposure to the counterparty. If the deliverables have not been received by the fifth business day after the due date, 50 percent of the current market value must be deducted from Tier 1 capital and 50 percent must be deducted from Tier 2 capital.

### F. Securitizations

This provision of the Proposed Rule is meant to address the risk associated with securities exposures arising from traditional or synthetic securitizations where the underlying risk is from financial rather than operating exposures. Generally, this will include any exposure representing a tranched credit exposure to a pool of financial assets (e.g., asset and mortgage-backed securities). The Basel Committee and the U.S. federal banking regulators have struggled for many years with the appropriate risk-based capital rules for

securitizations, and the rules in this area have already been revised several times. Currently, securitizations are risk-weighted based on external ratings of the exposures themselves (rather than the external rating of the issuing or sponsoring institution). The Proposed Rule embraces a similar, though more complex philosophy.

1. Risk-Weighted Asset Calculation.

The Proposed Rule sets up a hierarchy for determining the risk weight of a securitization exposure. First, any gains on sale must be deducted from Tier 1 capital and any remaining CEIOs must be deducted from total capital. Second, a ratings-based approach (RBA) is applied to qualifying exposures. The RBA applies to an originating banking organization if (i) the exposure has two or more external ratings or (ii) the exposure has two or more external or inferred ratings. The RBA applies to an investing banking organization if the exposure has one or more external or inferred ratings. Risk weights are assigned from 20 to 350 percent based on long-term credit ratings from the highest investment grade to one category below investment grade, and 20 to 100 percent based on short-term credit ratings from the highest investment grade to the lowest investment grade rating.

Third, if the exposure does not qualify for the RBA (i.e., there are not sufficient ratings for the originator or for the exposure), but the exposure is a senior securitization exposure such as an eligible asset-backed commercial paper (ABCP) facility, a first priority securitization exposure or an exposure in a second loss position or better to an ABCP program, the Proposed Rule provides different methods for risk-weighting each of these exposures. Finally, any remaining securitization exposures (i.e., unrated and senior securitization exposures) must be deducted from total capital — 50 percent from Tier 1 and 50 percent from Tier 2.

Where a banking organization has multiple securitization exposures that provide duplicative coverage to the underlying exposure (e.g., when a banking organization provides a program-wide credit enhancement and multiple pool-specific liquidity facilities to an ABCP program), duplicative risk-based capital requirements are not required. Rather, the banking organization applies the applicable risk-based capital treatment with the highest capital requirement. This approach is consistent with the current risk-based capital rules.

2. Servicer Cash Advance Facilities.

The Proposed Rule considers servicer cash advance facilities to be securitization exposures similar to mortgage servicer cash advances under the general risk-based capital rules. Under the Proposed Rule, risk-based capital for the drawn portion of servicer cash advance facilities are calculated as appropriate under the RBA or nonRBA. Consistent with general risk-based capital rules, there are no capital requirements for the undrawn portion of "eligible"[25] servicer cash advance facilities. The undrawn portions of

[25] An "eligible" servicer cash advance facility is a facility where (i) the servicer is entitled to full reimbursement of advances, with certain limited exceptions; (ii) the servicer's right to reimbursement is

noneligible facilities are treated as securitization exposures subject to the RBA or nonRBA, as applicable.

3. Implicit Support.

Where a banking organization provides implicit support — support to a securitization in excess of its predetermined contractual obligation — there are certain regulatory implications. First, the organization must hold capital against the entire exposure as if it were not securitized, and it must deduct from Tier 1 capital the gain on sale resulting from the securitization. Second, the organization must publicly disclose (i) that it is providing implicit support and (ii) the regulatory capital implications of such support. This is consistent with the general risk-based capital rules.

In the context of implicit support, the preamble to the Proposed Rule notes that the agencies have published a "significant" amount of supervisory guidance over the last several years with respect to the capital treatment of securitizations. The preamble notes that most of the guidance will remain applicable to the Standardized Approach for securitizations and states that the agencies expect banking organizations to continue to use the guidance. This discussion would suggest that the Interagency Guidance on Implicit Recourse in Asset Securitizations will continue to apply.

4. Credit Risk Mitigants.

With respect to credit risk mitigants for securitization exposures under the Proposed Rule, the approaches for recognizing financial collateral and eligible guarantee or eligible credit derivatives elsewhere in the Proposed Rule generally can be used for securitization exposures subject to certain specific provisions related to securitizations.

5. Revolving Securitizations with Early Amortization Provisions.

Consistent with the current risk-based capital rules, the Proposed Rule requires an originating banking organization to hold risk-based capital against its own interest and the interests of the investors (both drawn and undrawn) in a revolving securitization that contains an early amortization provision (EAP).[26] The purpose of the capital requirement is to recognize the risk to capital if the banking organization could be required to finance new draws with on-balance sheet funding sources. The Proposed Rule's treatment of early amortization provisions is similar to that in the Advanced Approach.

The maximum total capital requirement for exposure to a single securitization with an EAP is the greater of the capital requirement for (i) retained securitization exposures or (ii) the underlying exposure that would apply if directly held by the banking organization

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.

[26] The Proposed Rule defines an EAP as one that would require the securitization to wind down and repay investors if the excess spread falls below a certain threshold.

on its balance sheet. The banking organization calculates the risk-weighted amount for its own interest in the securitization as provided above in Section F.1. The risk-weighted amount for the investors' interest in the securitization is calculated by multiplying the following: (i) the investors' interest;[27] (ii) the appropriate conversion factor (CF); (iii) the weighted-average risk weight that would apply to the underlying exposure as if not securitized; and (iv) the proportion of the underlying exposure in which the borrower is permitted to vary the drawn amount within an agreement limit under the line of credit. This calculation varies from that under the current risk-based capital rules. As set forth in the table below, taken from the Proposed Rule, the appropriate CF for controlled EAP[28] uncommitted retail credit lines ranges from zero to 90 percent depending on the ratio of the three-month average annualized excess spread[29] divided by the excess spread trapping point in the securitization structure. The CF for all other controlled EAP revolving exposures is 90 percent.

Controlled Early Amortization Provisions

| | 3-month average annualized excess spread | Uncommitted CF (in percent) | Committed CF (in percent) |
|---|---|---|---|
| Retail Credit Lines | ≥ 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 | |
| Nonretail Credit Lines | | 90 | 90 |

As set forth in the table below, taken from the Proposed Rule, the appropriate CFs for uncommitted revolving retail exposures with non-controlled EAPs range from zero to

[27] The Proposed Rule defines the investors' interest as 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.
[28] A controlled EAP is defined under the Proposed Rule as one that meets the following criteria: (i) The originating banking organization has appropriate policies and procedures to ensure the availability of sufficient capital and liquidity in the event of an early amortization; (ii) for the life of the securitization, the pro rata sharing of interest, principal, expenses, losses, fees, recoveries and other cash flows from the underlying exposures are the same based on the originating banking organization's 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 be repaid or recognized as in the 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. Noncontrolled EAPs are those that do not meet the above criteria.
[29] Under the Proposed Rule, the excess spread for a period is (i) the gross finance charge collections and other income received by the SPE (including market interchange fees) over a period minus the interest paid to the holders of the 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.

100 percent, depending on the excess spread calculation. The CF for all other noncontrolled EAP revolving exposures is 100 percent.

Noncontrolled Early Amortization Provisions

| | 3-month average annualized excess spread | Uncommitted CF (in percent) | Committed CF (in percent) |
|---|---|---|---|
| Retail Credit Lines | ≥ 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 | |
| Nonretail Credit Lines | | 100 | 100 |

Home equity line of credit (HELOC) securitizations are addressed separately by the Proposed Rule because such securitizations generally do not generate material excess spread and are often structured with credit enhancements and early amortization triggers based on different factors than other revolving exposures. The Proposed Rule provides two options for the treatment of HELOC securitizations. The first option is to apply the appropriate CF already set forth for other EAP revolving exposures. The second option is to apply a fixed CF of 10 percent. If a banking organization chooses the second option, the fixed 10 percent CF would then be required for all securitizations with underlying HELOC exposures. This approach is consistent with the current risk-based capital rules.

## G. Equities

Under the Proposed Rule, for equity exposures that are not investment funds, the risk-weighted amount is generally calculated according to the simple risk-weight approach (SRWA). Under the SRWA, the adjusted carrying value[30] for each individual exposure or the effective portion or ineffective portion of a hedge pair[31] is multiplied by the lowest applicable risk weight. Risk weights range from zero percent for certain equity exposures

[30] Under the Proposed Rule, the adjusted carrying value for the on-balance sheet component of an equity investment is the banking organization's carrying value reduced by any unrealized gains on the exposure that are reflected in the carrying value but not excluded from Tier 1 or Tier 2 capital. The adjusted value for the off-balance sheet component of an equity exposure that is not an equity commitment is 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 for a given small change in the price of the underlying equity interest minus the adjusted carrying value of the on-balance sheet component. The adjusted carrying value for an equity commitment is the effective notional principal amount of the exposure multiplied by one of the following conversion factors: (i) 20 percent for conditional equity commitments with an original maturity of one year or less; (ii) 50 percent for conditional equity commitments with an original maturity over one year; and (iii) 100 percent for unconditional equity commitments.

[31] With respect to hedge transactions, a hedge pair under the Proposed Rule 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.

to sovereigns, supranational entities, MDBs and PSEs, to 600 percent for equity exposures to leveraged investment firms. The risk weight is 300 percent for publicly traded equity exposures and 400 percent for nonpublicly traded equity exposures.

Under the Proposed Rule, the risk-weighted amount of investment fund exposures, except certain community development investment equity exposures (which are risk-weighted under the SRWA), is determined according to one of three look-through approaches or, if applicable, the Money Market Fund Approach. A banking organization may choose a different approach among the four alternatives for different equity exposures to investment funds.

Under the Full-Look-Through Approach, the risk-weighted amount is determined by multiplying (i) the aggregate risk-weighted amounts of the exposures held by the fund as if held directly by the banking organization; and (ii) the banking organization's proportional ownership share of the funds. This approach is available only to banking organizations able to calculate a risk-weighted amount for their proportional ownership share of each exposure held by the fund.

Under the Simple Modified Look-Through Approach, the risk-weighted amount is determined by multiplying the adjusted carrying value of the exposure by the highest risk weight applicable to any exposure the fund is permitted to hold under its prospectus, partnership agreement or similar contract defining the fund's permissible investments.

Under the Alternative Modified Look-Through Approach, the adjusted carrying value of an equity exposure to an investment fund may be assigned, on a pro rata basis, to different risk weight categories based on the investment limits in the fund's agreement defining permissible investments. The risk-weighted amount for the exposure to the investment fund would then be the sum of each portion of the adjusted carrying value assigned to an exposure class multiplied by the applicable risk weight.

Under the Money Market Fund Approach, the risk-weighted amount for exposures to an investment fund that is a money market fund subject to 17 C.F.R. § 270.2a-7 that has an applicable external rating in the highest investment grate rating category is the adjusted carrying value of the exposure multiplied by seven percent.

## H. Operational Risk

Operational Risk has been defined by the Basel Committee as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. It includes legal risk, but excludes strategic and reputational risks. Within operational risk, the Basel Committee has identified seven operational event types, including internal fraud; external fraud; employment practices and workplace safety; clients, products and business practices; damage to physical assets; business disruption and system failures; and execution, delivery and process management.[32] The requirements under the current risk-based capital rules are generally considered broad enough to cover these types of

[32] *See* Basel Committee's Sound Practices for the Management and Supervision of Operational Risk.

risk. Under the more risk-sensitive Basel II framework, it has been determined that a specific capital charge is necessary to recognize operational risk.

Under the Proposed Rule, the capital charge for operational risk is calculated using the BIA. The BIA sets risk-weighted assets for operational risk as equal to 15 percent of the banking organization's average positive annual gross income over the previous three years multiplied by 12.5. The average positive annual gross income is the sum of the banking organization's positive annual gross income[33] over the three most recent calendar years divided by the number of those years in which its annual gross income is positive. Amounts from any year with a negative or zero annual gross income are excluded from the calculation.

**PILLAR 2 – SUPERVISORY REVIEW**

The focus of Basel II's Pillar 2 is the supervisory process which emphasizes (1) banking organization processes for assessing overall capital adequacy commensurate with risk profile and strategies for maintaining capital levels; (2) supervisory review of internal capital adequacy assessments and strategies and monitoring compliance with regulatory capital ratios; (3) banking organization operation above minimum capital ratios and supervisory authority to require holdings in excess of minimum requirements; and (4) early supervisory intervention and rapid remedial action.

Consistent with Pillar 2, the Proposed Rule requires

- capital commensurate with the level and nature of the risks to which the banking organization is exposed;
- banking organization processes for assessing overall capital adequacy in relation to its risk profile, and comprehensive strategies for maintaining appropriate levels of capital.

Current supervisory guidance already permits a banking organization's primary federal regulator to (1) evaluate its compliance with minimum capital requirements; (2) evaluate how well a banking organization is assessing its capital needs relative to its risks and capital goals and (3) require a banking organization to increase its capital levels or reduce risk exposure if the banking organization's capital is not commensurate with its risk profile.

**PILLAR 3 – MARKET DISCIPLINE**

The focus of Basel II's Pillar 3 is the encouragement of market discipline through enhanced and meaningful public disclosure. To that end, the Proposed Rule subjects a banking organization's top-tier legal entity within a consolidated group to public disclosure requirements. This entity would be required to have a board-approved formal disclosure policy addressing the organization's approach for determining required

[33] The Proposed Rule provides a definition of "annual gross income" for each type of banking organization.

disclosures, associated internal controls and disclosure controls and procedures. The Proposed Rule includes 10 tables of required disclosures categorized as follows:

- Scope of application;
- Capital structure;
- Capital adequacy;
- Credit risk: general disclosures;
- General disclosure for counterparty credit risk-related exposures;
- Credit risk mitigation;
- Securitization;
- Operational risk;
- Equities not subject to the MRR; and
- Interest rate risk for nontrading activities.

Some disclosures are already required by accounting standards, SEC mandates or regulatory reporting. A banking organization may use these disclosures to satisfy, where appropriate, those required under the Proposed Rule, so long as any material differences are explained.

The Proposed Rule requires quantitative disclosures to be made quarterly, and qualitative disclosures to be made annually, provided disclosures of any significant changes are made in the interim. The disclosures must be publicly available for each of the last three years. The Proposed Rule encourages banking organizations to provide all required disclosures in one place on the banking organization's public website. At a minimum, a banking organization must publicly provide a summary table that specifically indicates where all disclosures may be found.

The Proposed Rule recognizes that the disclosure of certain information may be proprietary and confidential; while the Proposed Rule would not require a banking organization to disclose such information, it would require the banking organization to disclose more general information about the subject matter, together with acknowledgement that the specific information has not been disclosed and the reason for nondisclosure.