December 7, 2011

MEMORANDUM TO: Board of Directors

FROM: Sandra L. Thompson, Director
Division of Risk Management Supervision

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

Proposal: Staff recommends that the FDIC Board ("Board") approve the attached joint Notice of Proposed Rulemaking ("NPR") titled, *Risk-Based Capital Guidelines: Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions*. If approved, this NPR would be published jointly in the *Federal Register* by the FDIC, the Board of Governors of the Federal Reserve System ("FRB"), and the Office of the Comptroller of the Currency ("OCC") (together, "the agencies") for a public comment period that would close on February 3, 2012.

This NPR is an amendment to the notice of proposed rulemaking that was published in the *Federal Register* on January 11, 2011, to modify the agencies' current market risk rules ("January 2011 NPR"). The January 2011 NPR did not propose certain methodologies adopted by the Basel Committee on Banking Supervision ("BCBS") for calculating the capital requirements for certain debt and securitization positions because the BCBS methodologies rely on the use of credit ratings. Under section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), each federal agency is to review any regulations that require the use of an assessment of the credit-worthiness of a security or money market instrument and any references regarding credit ratings and, following the review, remove references to or requirements of reliance on credit ratings and substitute a standard of credit worthiness that the agency determines is appropriate for the regulation. The FDIC has completed the required review. In this NPR, the agencies are proposing to incorporate into the market risk capital rules alternative methodologies for calculating capital requirements for debt and securitization positions to comply with the requirements of section 939A of the Act.

Concur:

Michael H. Krimminger 12/1/11
Michael H. Krimminger
General Counsel

Summary: The Division of Risk Management Supervision recommends that the Board approve for publication in the *Federal Register* the attached interagency NPR, which seeks comment on alternatives to the use of external credit ratings when assigning capital requirements to certain debt and securitization positions in the market risk rule. The agencies expect to finalize this NPR, together with any changes to the January 2011 NPR in early 2012. The agencies believe that it is important to align the methodologies for calculating the capital requirements in the market risk rule with similar positions under the general risk-based capital rules in order to reduce the potential for regulatory capital arbitrage. Accordingly, the agencies intend to propose at a later date, revisions to their general risk-based capital rules by incorporating creditworthiness standards for debt and securitization positions similar to the standards included in this NPR.

Discussion:

<u>Background</u>

Under the agencies' existing market risk capital rules,[1] the capital requirement for debt and securitization positions consists of general market and specific risk components. General market risk is defined as changes in the market value of positions resulting from broad market movements, such as changes in the general level of interest rates, foreign exchange rates or commodities prices. Specific risk is defined as changes in the market value of a position due to factors other than broad market movements, and includes event and default risk, as well as idiosyncratic risk.

In 2005 and 2009, the BCBS introduced several enhancements to the market risk capital framework[2], particularly with respect to the specific risk capital treatment for securitization positions (the "Basel II Revisions"). Among other things, the BCBS revisions provide for the use of credit ratings to determine the specific risk add-on for a debt position under the standardized method. With respect to a securitization position, the BCBS revisions significantly

[1] *See* 12 CFR part 3, appendix B (OCC); 12 CFR parts 208 and 225, appendix E (FRB); 12 CFR part 325, appendix C (FDIC).

[2] *See, The Application of Basel II to Trading Activities and the Treatment of Double Default Effects*, published jointly by the International Organization of Securities Commissions and the Basel Committee; *Revisions to the Basel II Market Risk Framework, Guidelines for Computing Capital for Incremental Risk in the Trading Book* and *Enhancements to the Basel II Framework* (2009).

increase the specific risk-weighting factors and delineate between securitization and re-securitization positions, with the latter subject to a relatively higher specific risk capital charge. This treatment effectively applies the banking book capital charges[3] to securitization and re-securitization positions in the trading book, and was designed to address regulatory arbitrage opportunities as well as deficiencies in the modeling of securitization positions that became more evident during the course of the financial crisis.

As a result of the enactment of section 939A of the Act, the agencies are not implementing the specific risk add-ons for debt and securitization positions, as provided in the Basel II Revisions.

<u>The Proposed Rule</u>

The rule proposed in this NPR would amend the January 2011 NPR and solicit public comment on various methodologies for determining the specific risk capital requirement for debt and securitization positions under the market risk rule. The proposed rule includes several approaches to assigning capital requirements for various debt and securitization positions for purposes of the market risk rule. The approaches generally rely on objective, publically available data which ensure that the minimum capital requirements would be consistently applied across different banking organizations of varying size and complexity. Staff believes that the approaches provided below are consistent with and as conservative as the approached provided in the Basel II Accord,[4] including the 2005 and 2009 revisions to the Basel II Accord. .

Securitization Positions

For securitization positions, staff has developed a simplified supervisory formula approach ("SSFA") based on the supervisory formula approach included in the agencies' Basel II advanced approaches rules. The SSFA is designed to apply relatively high capital requirements to the more subordinated, risky tranches of a securitization that are the first to absorb losses and relatively lower requirements to the most senior positions.

[3] The term "banking book capital charges" refers to the general risk-based and advanced approaches capital rules, as applicable.
[4] *See* BCBS, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Comprehensive Version* (June, 2006).

Staff believes the SSFA would provide a simple, straightforward methodology for determining the specific risk add-on for a securitization position under the market risk rule. To use the SSFA, a bank would apply the following inputs, which are publically available from servicer reports, to a formula provided in the proposed rule:

(i) The weighted average risk weight of the underlying assets, determined in accordance with the general risk-based capital rules (K_G);

(ii) The attachment point of the relevant tranche. This represents the threshold at which credit losses would first be allocated to the tranche. (Parameter A);

(iii) The detachment point of the tranche. This represents that threshold at which credit losses allocated to the tranche would result in a total loss to the investor in the tranche. (Parameter D);

(iv) The securitization surcharge. This is a supervisory calibration input. For securitization positions this input is 0.5, and for re-securitization exposures it is 1.5; and

(v) Cumulative losses on the pool of underlying assets as a percent of the amount of capital that would be required to be held against the pool at origination if the pool was held directly on-balance sheet by a banking organization.

Staff is proposing to apply a supervisory minimum risk weight floor, as provided in Table A, which will increase as cumulative losses to the pool increase over time, as a percentage of the general risk-based capital requirement. Staff believes that some minimum amount of prudential capital requirement is appropriate because during the recent financial crisis a number of very highly-rated senior securitization positions were downgraded and experienced significant losses. The NPR also seeks comment on whether to include an adjustment factor that would increase or decrease the total amount of capital required for certain securitizations at their inception.

Table A – Supervisory Minimum Risk Weighting Factors for Securitization Tranches

Cumulative losses of Principal on Originally Issued Securities as a percent of K_G at origination		Minimum Risk-Weighting Factor
Greater than:	Less than or equal to:	
0	50	1.6
50	100	8.0
100	150	52.0
150	n/a	100.0

Under certain circumstances, the SSFA may produce a specific risk add-on for a securitization position that exceeds the specific risk add-on that would otherwise be generated by the ratings-based approach ("RBA"), as set forth in the Basel II 2005 and 2009 revisions. Accordingly, the agencies would seek comment ways to better align the SSFA and RBA, including through the use of a scaling factor to adjust the SSFA for certain securitization positions or asset classes.

Sovereign Debt Positions

Under the proposed rule the specific risk-weighting factor for a sovereign debt position would be based on the Organization for Economic Co-operation and Development ("OECD") Country Risk Classification ("CRC") [5] for the sovereign in accordance with Table B. The CRC methodology categorizes countries into one of eight risk categories (0-7).

[5] Please refer to http://www.oecd.org/document/49/0,3343,en_2649_34169_1901105_1_1_1_1,00.html for more information on the OECD country risk classification methodology.

Table B – Sovereign Debt Positions

Sovereign CRC	Risk-Weighting Factor (in percent)	
0-1	0.0	
2-3	Residual term to final maturity 6 months or less	0.25
	Residual term to final maturity greater than 6 months and up to and including 24 months	1.0
	Residual term to final maturity exceeding 24 months	1.6
4-6	8.0	
7	12.0	
No CRC	8.0	

Staff believes that CRCs would provide a reasonable alternative to the use of credit ratings by credit rating agencies under the market risk rules. The use of CRCs presents several important advantages in that they are available for over 150 countries, and they are available to the public and updated regularly by the OECD. However, under the CRC methodology, all OECD member countries receive the most favorable CRC (zero) and, therefore, it does not meaningfully differentiate the relative credit risk of the OECD members. To alleviate concerns about the potential for CRC misclassifications, under the proposed rule a bank would assign a specific risk-weighting factor of 12.0 to a debt position of a sovereign that has defaulted on any exposure during the previous five years.

Debt positions of U.S. government and its agencies would receive a specific risk-weighting factor of zero, while debt positions of a sovereign entity with no CRC would a risk-weighting factor of 8.0.

Exposures to Depository Institutions, Foreign Banks, and Credit Unions

The proposed rule would assign a specific risk-weighting factor to debt positions of these entities based on the CRC of the sovereign of incorporation, in accordance with Table C. If an entity's sovereign of incorporation does not have a CRC, debt positions of a depository institution, foreign bank, and credit union incorporated in the sovereign would also receive a specific risk-weighting factor of 8.0.

Table C – Debt Positions of Depository Institutions, Foreign Banks, and Credit Unions

CRC of Sovereign of Incorporation	Risk-Weighting Factor (in percent)	
0-2	Residual term to final maturity 6 months or less	0.25
	Residual term to maturity up to and including 24 months	1.0
	Residual term to final maturity exceeding 24 months	1.6
3	8.0	
4-7	12.0	
No CRC	8.0	

Public Sector Entity Debt Positions

The proposed rule would assign a debt position of a public sector entity ("PSE") a specific risk-weighting factor based on the CRC assigned to the PSE's sovereign of incorporation, the repayment structure of the position, and whether the debt position represents the general obligation of the PSE (Table D) or a revenue obligation (Table E). This approach would apply to both general obligation claims and revenue obligations. If the sovereign of incorporation does not have a CRC rating, debt positions of a PSE within its jurisdiction would also receive a specific risk-weighting factor of 8.0.

Table D – PSE General Obligation Debt Positions

Sovereign Entity CRC	General Obligation Risk-Weighting Factor (in percent)	
0-2	Residual term to final maturity 6 months or less	0.25
	Residual term to maturity up to and including 24 months	1.0
	Residual term to final maturity exceeding 24 months	1.6
3	8.0	
4-7	12.0	
No CRC	8.0	

Table E – PSE Revenue Obligation Debt Positions

Sovereign Entity CRC	Revenue Obligation Risk-Weighting Factor (in percent)	
0-1	Residual term to final maturity 6 months or less	0.25
	Residual term to maturity up to and including 24 months	1.0
	Residual term to final maturity exceeding 24 months	1.6
2-3	8.0	
4-7	12.0	
No CRC	8.0	

Corporate Debt Positions

The proposed rule would distinguish between financial and non-financial corporations, and between publicly-traded and private corporations. For a debt position of a publicly-traded non-financial company, the proposed rule would require a bank to assign a specific risk-weighting factor based on the leverage, profitability, and stock price volatility of the entity, in accordance with Table F, as supplemented by Table F-1. For purposes of Table F, the measure "EBITDA-to assets ratio" means a ratio calculated by dividing: (1) a corporate entity's earnings before interest expense, taxes, depreciation and amortization (EBITDA) using data from the four most recently reported calendar quarters; by (2) its equity market value plus total liabilities as reported as of the end of the most recent calendar quarter. For financial company debt positions and private company debt positions, the proposed rule would require a bank to assign a specific risk-weighting factor of 8.0%.

Table F – Debt Positions of a Publicly-Traded Non-Financial Company

EBITDA-to-assets ratio	Stock market Volatility measure	Debt-to-assets ratio less than 0.2	Debt-to-assets ratio between 0.2 and 0.5	Debt-to-assets ratio greater than 0.5
greater than zero	less than 0.1	See Table F1	8.0	8.0
	between 0.1 and 0.15	8.0	8.0	8.0
	greater than 0.15	8.0	8.0	12.0
less than zero	less than 0.1	8.0	8.0	8.0
	between 0.1 and 0.15	8.0	8.0	12.0
	greater than 0.15	12.0	12.0	12.0

Table F1 – Debt Positions of a Publicly-Traded Non-Financial Company

Remaining Contractual Maturity	Specific Risk-Weighting Factor (in percent)
Residual term to final maturity 6 months or less	0.25
Residual term to final maturity greater than 6 months and up to and including 24 months	1.0
Residual term to final maturity exceeding 24 months	1.6

Other Alternatives

The proposed rule also seeks comment on other alternatives to the use of credit ratings when assigning minimum capital requirements for debt and securitization positions in the market risk rule.

Recommendation:

The Division of Risk Management Supervision recommends that the Board approve for publication in the *Federal Register* the attached interagency NPR, which seeks comment on alternatives to the use of external credit ratings when assigning capital requirements to certain debt and securitization positions in the market risk rule.

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