June 12, 2012

MEMORANDUM TO: Board of Directors

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

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

Proposal: The Division of Risk Management Supervision recommends that the FDIC Board ("Board") approve the attached final rule titled, *Risk-Based Capital Guidelines: Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions*. If this final rule is approved, it would be published in the *Federal Register* jointly 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"). The final rule, which would be effective on January 1, 2013, modifies the scope of the existing market risk capital rules to better capture the risks of positions for which the current market risk capital rules are insufficient; reduces procyclicality in market risk capital requirements; enhances the rules' sensitivity to risks; increases transparency through enhanced disclosures; and provides alternative, non-ratings-based methodologies for calculating the specific risk capital requirements for debt and securitization positions.

Concur:

Richard J. Osterman, Jr.
Acting General Counsel

In January 2011, the agencies issued a joint notice of proposed rulemaking in the *Federal Register* ("January 2011 NPR")[1], which sought public comment on a proposal to implement the market risk portion of the Basel II framework, as amended by the Basel Committee on Banking Supervision ("BCBS") in 2005 and 2009, and to require banks with significant trading activity to continue to use internal models to calculate minimum regulatory market risk capital requirements for "covered positions."[2] The January 2011 NPR did not, however, propose certain methodologies adopted by the BCBS for calculating the market risk capital requirements for certain debt and securitization positions because the BCBS methodologies relied on the use of external credit ratings. Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Section 939A") directs federal agencies to review certain regulations for references to or requirements in such regulations regarding credit ratings and to substitute standards of e credit-worthiness the agencies determine to be appropriate. Accordingly, as part of the agencies' implementation of the Basel II market risk framework and Section 939A, in December 2011, the agencies issued a joint notice of proposed rulemaking in the *Federal Register* ("December 2011 Amendment")[3] that amended the January 2011 NPR and sought public comment on alternative methodologies for calculating specific risk capital requirements for debt and securitization positions that do not rely on credit ratings.

The agencies received a total of 35 comment letters on the January 2011 NPR and the December 2011 Amendment. The commenters generally supported the agencies' efforts to implement the Basel II market risk framework, but criticized certain aspects of the non-ratings-based methodologies for determining the specific risk capital requirements for debt and securitization positions under the December 2011 Amendment, particularly the simplified supervisory formula approach (the "SSFA") for securitization positions. In view of the comments, the agencies have revised certain elements of the

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[1] 76 Fed. Reg. 1890 (January 11, 2011).

[2] Under the proposed and final rules, with certain exceptions, a "covered position" means (1) a trading asset or trading liability (whether on- or off-balance sheet), as reported on the Call Report, that meets the following conditions: (i) the position is a trading position or hedges another covered position, and (ii) the position is free of any restrictive covenants on its tradability or the bank' is able to hedge the material risk elements of the position in a two-way market; and (2) a foreign exchange or commodity position.

[3] 76 Fed. Reg. 79380 (December 21, 2011).

January 2011 NPR and December 2011 Amendment. Most significantly, as described below, the final rule modifies the methodologies for determining the specific risk capital requirements for corporate debt and securitization positions.

The Division of Risk Management Supervision, with the concurrence of the Legal Division, recommends that the Board approve for publication in the *Federal Register* the attached interagency final rule.[4]

Discussion

Background

Under the agencies' existing market risk capital rules,[5] 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 (the "Basel II Revisions")[6]. Among other things, the Basel II Revisions narrow the types of positions that are subject to the market risk framework and revise the modeling standards and procedures for calculating minimum regulatory capital requirements. The Basel II Revisions also introduce an incremental risk capital

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[4] 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 are proposing revisions to their general risk-based capital rules by incorporating creditworthiness standards for debt and securitization positions similar to the standards included in this final rule.

[5] *See* 12 CFR part 3, appendix B (national banks); 12 CFR parts 208 (state member banks) and 225 (bank holding companies), appendix E; 12 CFR part 325, appendix C (state non-member banks). The Office of Thrift Supervision did not adopt a market risk capital rule for savings associations and savings and loan holding companies

[6] *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).

requirement to capture default and credit quality migration risk for certain covered positions; add a stressed value-at-risk ("VaR")-based capital requirement to the general VaR-based requirement under the existing market risk capital rules; require banks to apply standardized specific risk charges to all securitization positions that are not correlation trading positions; and permit a bank to measure all price risks of one or more portfolios of correlation trading positions using an internal model.

To address regulatory arbitrage opportunities as well as deficiencies in internal models that became more evident during the recent economic crisis, the Basel II Revisions provide for the use of credit ratings to determine the specific risk add-on for a debt and securitization positions under the standardized method. With respect to securitization positions, the Revisions significantly increase the specific risk-weighting factors[7] and delineate between securitization and re-securitization positions, with the latter category subject to a relatively higher specific risk capital charge. This treatment effectively applies the banking book capital charges[8] to securitization and re-securitization positions in the trading book.

In view of the requirements of Section 939A, the agencies were unable to implement the specific risk add-ons for debt and securitization positions, as provided in the Basel II Revisions, because they relied on ratings from credit rating agencies. Therefore, the agencies were required to establish alternative methodologies for calculating capital requirements for debt and securitization positions.

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[7] In the context of the market risk capital rules, the specific risk-weighting factor is a scaled measure that is similar to the risk weights used for purposes of the general risk-based capital rules (that is, the zero, 20 percent, 50 percent, and 100 percent risk weights) for determining risk-weighted assets. The measure for market risk is multiplied by 12.5 to covert it to market risk equivalent assets, which are then added to the denominator of the risk-based capital ratio.

[8] The term "banking book capital charges" refers to the general risk-based and advanced approaches capital rules, as applicable.

The Final Rule

The final rule adopts the January 2011 NPR and December 2011 amendment with certain changes in response to concerns raised by the commenters. These changes are discussed briefly in this document.

Securitization Positions

In the December 2011 Amendment, the agencies proposed to require banks to determine the specific risk capital requirement for a securitization position using the SSFA, based on the supervisory formula approach included in the agencies' Basel II advanced approaches rules.

Under the proposed SSFA, a bank would be required to incorporate the following inputs, which are publicly-available from servicer reports, into the formula provided in the proposed rule:

(i) The weighted average total capital requirement 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);

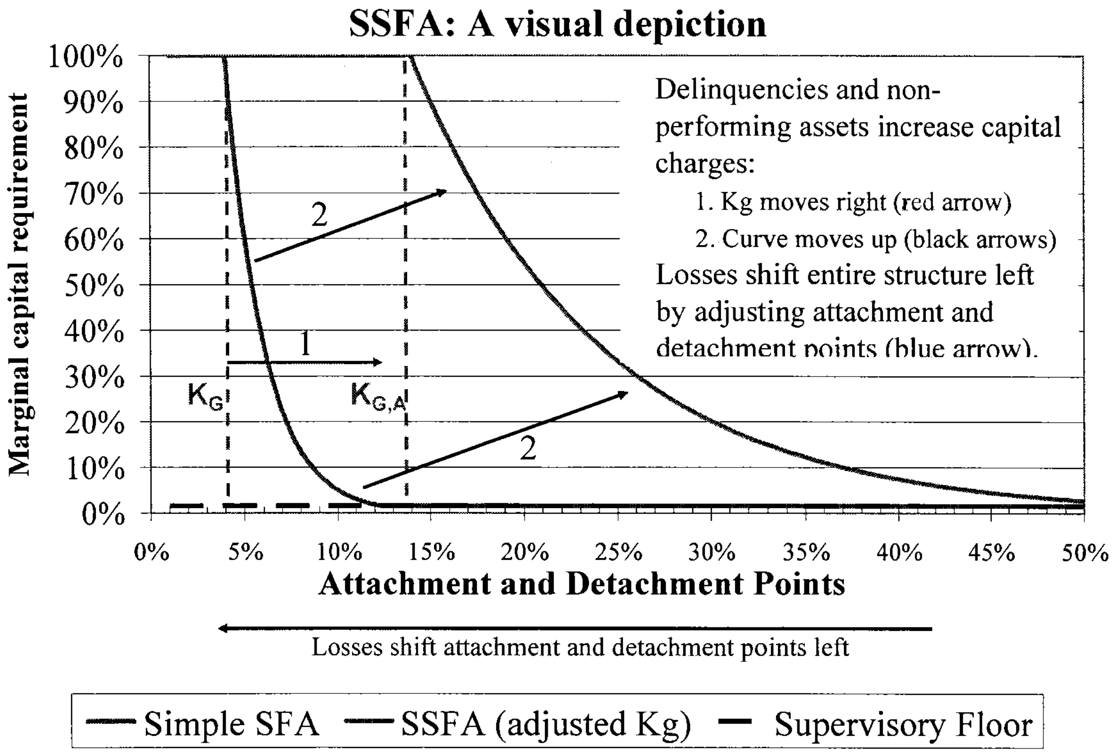
(iii) The detachment point of the tranche. This represents that threshold at which credit losses allocated to the tranche would result in a total loss to the investor in the tranche. (Parameter D);

(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. This parameter is used to determine the supervisory minimum risk weight floor.

For purposes of the final rule and in view of the commenters' concerns regarding the December 2011 Amendment, the agencies have revised the SSFA as follows. To address concerns regarding the failure of the proposed SSFA to recognize certain structural features and credit enhancements designed to mitigate credit risk, the agencies have revised the supervisory minimum risk weight floor, which would have increased as cumulative losses of the securitization increased over time, as a percentage of the general risk-based capital requirement. Under the final rule, the supervisory minimum risk weight floor is fixed at 1.6 percent (that is, no securitization position shall receive a specific risk capital charge of less than 1.6 percent – this corresponds to a 20% risk weight).

As an alternative to a flexible floor that increases as the underlying assets exhibit a deterioration in credit quality, under the final rule, the risk weight applicable to the underlying exposures, K_G, adjusts based on the percentage of securitized assets that are 90 days or more past due or experiencing some other credit event (for example in foreclosure or default). The adjusted K_G parameter is referenced as K_A in the final rule. The effect of this change is depicted in the illustration below. As the securitized assets experience delinquencies or more severe credit events, K_G moves rightward, thereby increasing the specific risk capital charge on the securitization positions. In addition, where the tranches of the securitization experience losses, the attachment and detachment points move leftward – such an event also increases the specific risk capital charges on the securitization positions.



Consistent with the December 2011 Amendment, under the final rule, if a bank is unable or chooses not to use the SSFA, the securitization position would be subject to the gross-up method, which is the methodology provided under the existing general risk-based capital rules for determining the risk weight for a securitization exposure.[9]

Consistent with the Basel II revisions, the January 2011 NPR would allow a bank to model all material price risk of a correlation trading position using a comprehensive risk model, and subject to surcharge equal to 15 percent of the total specific risk capital requirement that would apply to such position. The commenters criticized the proposed surcharge as overly conservative and inconsistent with the Basel II revisions, which contemplate a supervisory floor approach. The agencies continue to believe that a surcharge is appropriate in view of the prudential challenges associated with relying solely on banks' comprehensive risk models for determining risk-based capital

[9] Under the gross-up method, a bank holding a subordinated securitization position is required to hold risk-based capital against its position and all of the positions more senior to its positions.

requirements for correlation trading positions, and provides a prudential backstop as well as appropriate incentives for ongoing model improvement. However, in view of the commenters concerns the agencies have reduced the surcharge to 8 percent for purposes of the final rule.

Sovereign Debt Positions

Under the December 2011 Amendment, 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")[10] for the sovereign in accordance with Table A. The CRC methodology categorizes countries into one of eight risk categories (0-7).

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[10]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 A – Sovereign Debt Positions

<table>
<tr><th>Sovereign CRC</th><th colspan="2">Risk-Weighting Factor
(in percent)</th></tr>
<tr><td>0-1</td><td colspan="2">0.0</td></tr>
<tr><td rowspan="3">2-3</td><td>Residual term to final maturity 6 months or less</td><td>0.25</td></tr>
<tr><td>Residual term to final maturity greater than 6 months and up to and including 24 months</td><td>1.0</td></tr>
<tr><td>Residual term to final maturity exceeding 24 months</td><td>1.6</td></tr>
<tr><td>4-6</td><td colspan="2">8.0</td></tr>
<tr><td>7</td><td colspan="2">12.0</td></tr>
<tr><td>No CRC</td><td colspan="2">8.0</td></tr>
</table>

The agencies have retained the CRC methodology, as proposed in the December 2011 Amendment, for purposes of the final rule. The agencies believe that CRCs provides a reasonable alternative to the use of credit ratings under the market risk rules. The use of CRCs presents several important advantages in that they are available for over 150 countries, and are publicly-available and updated regularly by the OECD. 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.

Consistent with the December 2011 Amendment, under the final rule 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 final rule does not revise the proposed treatment in the December 2011 Amendment for determining the specific risk capital requirement for a debt position to a depository institution, foreign bank, or credit union under the December 2011 Amendment. This approach assigns a specific risk-weighting factor to debt positions of these entities based on the CRC of the sovereign of incorporation, in accordance with Table B. 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 B – 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 final rule does not revise the proposed treatment for determining the specific risk capital requirement for a debt position to a public sector entity ("PSE") debt positions under the December 2011 Amendment. This approach assigns a PSE debt position 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 C) or a revenue obligation (Table D). This approach applies to both general and revenue obligations of a PSE. 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 C – 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 D – 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

In proposing a new methodology for corporate debt positions for purposes of the December 2011 Amendment, the agencies distinguished 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 December 2011 Amendment would have required a bank to assign a specific risk-weighting factor based on the leverage, profitability, and stock price volatility of the entity. The commenters generally criticized this indicator-based methodology for introducing significant complexity to the market risk rules without added risk-sensitivity. Accordingly, under the final rule the agencies have replaced the indicator-based methodology with an approach that assigns assign a specific risk-weighting factor to a non-financial corporate debt position based on the maturity of the position and whether it is investment grade, based on the definition of "investment grade" in the final rule. Under the final rule, a corporate debt position qualifies as investment grade if the bank determines that the counterparty to the transaction has an adequate financial capacity to meet financial commitments for the projected life of the asset or exposure. A counterparty has an adequate capacity to meet financial commitments if the risk of its default is low and the full and timely repayment of principal and interest is expected. In contrast to the proposed indicator-based methodology under the December 2011 Amendment, the final rule does not distinguish between publicly-traded and private corporations. The resulting capital charges for non-financial companies would be as follows (Table E):

Table E: Non-Financial Corporate Exposures

<table>
<tr><th>Category</th><th colspan="2">Risk-Weighting Factor (in percent)</th></tr>
<tr><td rowspan="3">Investment grade</td><td>Residual term to final maturity 6 months or less</td><td>0.5</td></tr>
<tr><td>Residual term to maturity up to and including 24 months</td><td>2.0</td></tr>
<tr><td>Residual term to final maturity exceeding 24 months</td><td>4.0</td></tr>
<tr><td>Non-investment grade</td><td colspan="2">12.0</td></tr>
</table>

Consistent with the December 2011 Amendment, for a corporate debt position to a financial company, the final rule would require a bank to assign a specific risk-weighting factor of 8.0 percent.

Recommendation

The Division of Risk Management Supervision recommends that the Board approve for publication in the *Federal Register* the attached interagency final rule, which modifies the scope of the existing market risk capital rules to better capture positions for which the market risk capital rules are appropriate; reduces procyclicality in market risk capital requirements; enhances the rules' sensitivity to risks that are not adequately captured under the current regulatory measurement methodologies; increases transparency through enhanced disclosures; and includes alternative methodologies for calculating specific risk capital requirements for debt and securitization positions that do not rely on credit ratings.

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