June 12, 2012

MEMORANDUM TO: Board of Directors

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

SUBJECT: Notice of Proposed Rulemaking Regarding *Advanced Approaches Risk-based Capital Rules; Market Risk Capital Rules*

Proposal: That the Board of Directors ("Board") of the Federal Deposit Insurance Corporation ("FDIC") approve publication of the attached Notice of Proposed Rulemaking titled, *Advanced Approaches Risk-based Capital Rules; Market Risk Capital Rules* ("Advanced Approaches NPR", "NPR" or "proposed rule"), in the *Federal Register* for a 90-day comment period. The NPR would be issued on an interagency basis by the FDIC, the Board of Governors of the Federal Reserve System ("FRB"), and the Office of the Comptroller of the Currency ("OCC") ("the agencies"). The proposed rule would amend the advanced approaches risk-based capital rules ("advanced approaches rules") to incorporate aspects of the Basel III Framework and other revisions to the Basel capital framework published by the Basel Committee on Banking Supervision ("BCBS") in a series of documents released between 2009 and 2011 and recent consultative papers. The NPR also would remove references to credit ratings, consistent with the requirements of section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). This NPR also proposes to apply the market risk capital rules to state savings associations.

Today, staff also will present to the Board two additional notices of proposed rulemaking that, if approved, would be published jointly by the agencies in the *Federal Register* on the same day as the Advanced Approaches NPR, for a 90-day comment

Concur:

Richard J. Osterman, Jr.
Acting General Counsel

period.

The Basel III NPR would amend the current leverage and general risk-based capital rules to incorporate revisions to the Basel capital framework established by the BCBS in *Basel III: A global regulatory framework for more resilient banks and banking systems*. Another NPR, the Standardized Approaches NPR, would revise the methodologies for determining risk-weighted assets under the general risk-based capital rules with a Basel II-based standardized approach and other enhancements.

Advanced approaches banking organizations need to review both of those NPRs. The Basel III NPR includes a revised definition of capital, capital ratios, revised Prompt Corrective Action triggers and capital buffers that are proposed to apply to all banking organizations. That NPR also contains a supplementary Basel III Framework-based leverage ratio and countercyclical buffer requirements that apply only to advanced approaches banks. All banks would be permitted to implement the proposals in the Basel III NPR gradually, between January 1, 2013 and January 1, 2018, in accordance with the transitional framework set forth in that NPR. The Standardized Approach NPR proposes changes to risk-weighted asset methodologies that would apply to all banks including advanced approach banks, starting January 1, 2015, with an option to early adopt.

Staff notes that, for purposes of this NPR, the agencies would republish the entirety of the advanced approaches and market risk capital rules to facilitate the reorganization of the rules by the Federal Register in the Code of Federal Regulations. However, this NPR seeks comment only on the proposed revisions to the advanced approaches rules, as well as the application of the market risk rules to savings and loan holding companies and federal and state savings associations.

Recommendation: That the Board approve publication of the NPR for a 90-day public comment period.

Discussion

<u>Background</u>

To address weaknesses in the existing capital framework that were manifest during the recent financial crisis, the BCBS published *Basel III: A global regulatory framework for more resilient banks and banking systems* ("the Basel III Framework"). This NPR proposes to revise the advanced approaches rules to incorporate aspects of the Basel III Framework that the agencies believe should apply only to institutions using the advanced approaches rules. The NPR also proposes to incorporate revisions to the advanced approaches risk-based capital framework published by the BCBS in *Enhancements to the Basel II framework* ("BCBS Enhancements") and recent BCBS consultative papers, as well as alternatives to credit ratings consistent with section 939A of the Dodd-Frank Act.

The proposed rule would revise the agencies' advanced approaches rules to improve and strengthen modeling standards, the treatment of counterparty credit risk and securitization exposures, as well as disclosure requirements. However, consistent with section 939A of the Dodd-Frank Act the proposed rule would not include the BCBS Enhancements to the ratings based approach for securitization exposures because it relies on the use of credit ratings.

Summary of the NPR

Counterparty Credit Risk

Credit Valuation Adjustment ("CVA") Capital Requirement

A BCBS review of the treatment of counterparty credit risk found that roughly two-thirds of counterparty credit risk losses were due to mark-to-market loses from credit valuation adjustments ("CVA")[1], while one-third of such losses resulted from actual defaults. Accordingly, consistent with the Basel III Framework, the proposed rule would require a bank to directly reflect CVA risk through an additional capital requirement. The CVA capital requirement is designed to address a potential increase in CVA due to changes in counterparty credit spreads.

Under the proposed rule a bank may use one of two approaches to determine its

[1] CVA is defined as the fair value adjustment to reflect counterparty credit risk in the valuation of an OTC derivative contract.

CVA capital requirement, an advanced or simple CVA approach. The advanced CVA approach is based on the value-at-risk ("VaR") model used by a bank to calculate specific risk under the market risk rule. In contrast, the simple CVA approach is based on the use of a supervisory formula and internally-estimated probability-of-default.

Exposures to Central Counterparties

To incentivize the use of central counterparties ("CCPs") that satisfy internationally-recognized standards for settling and clearing processes (that is, "qualified central counterparties" or "QCCPs"), the NPR also proposes a more risk-sensitive treatment for transactions with CCPs, consistent with proposals in BCBS consultative papers published subsequent to the release of the Basel III Framework. Under the proposed rule, transactions conducted through a QCCP would receive a more favorable capital treatment relative to those conducted through a CCP. Similarly, the NPR would establish a capital requirement for a bank's default fund contribution[2] to a CCP, with a more favorable capital treatment for default fund contributions to a QCCP relative to those to a CCP.

Counterparty Credit Risk and Asset Value Correlation

The financial crisis also highlighted the interconnectedness of large financial institutions through an array of complex transactions. To recognize this interconnectedness and mitigate the risk of contagion from the banking sector to the broader financial system and the general economy, the proposed rule would provide enhanced requirements for the calculation of counterparty credit risk. In particular, the NPR would require a bank's risk-management processes to identify, monitor, and control wrong-way risk throughout the life of an exposure using stress testing and scenario analyses. In addition, the proposed rule would improve the internal models methodology ("IMM"), which is currently used by a bank to determine its capital requirement for counterparty credit risk under the advanced approaches rules, through additional

[2] Default fund contributions refer to the funds contributed or commitments made by clearing members to a CCP's mutualized loss sharing arrangement. Default funds are also known as clearing deposits or guaranty funds.

requirements for the use of stressed inputs and enhanced stress testing analyses.

To recognize the correlation among financial institutions to common risk factors, the agencies are proposing to incorporate the Basel III Framework increase in the correlation factor used to determine the capital requirement for certain "wholesale" exposures – that is, exposures to highly leveraged entities such as hedge funds and financial guarantors as well as exposures to regulated financial institutions with consolidated assets of greater than or equal to $100 billion.

With respect to counterparty credit risk more generally, the proposal also would increase the holding period and margin period of risk that a bank may use to determine its capital requirement for repo-style transactions, OTC derivatives, and eligible margin loans to address liquidity concerns that arose in settling or closing-out collateralized transactions during the recent crisis.

Securitizations and Disclosures

The recent financial crisis also demonstrated that resecuritization[3] exposures, such as CDOs comprised of ABS, generally present greater levels of risk relative to other securitization exposures due to their increased complexity, lack of transparency, and concentration of systemic risk. Accordingly, the BCBS Enhancements amended the Basel internal ratings-based approach to require a banking organization to assign higher risk weights to resecuritization exposures than other, similarly-rated securitization exposures. Consistent with the BCBS Enhancements, the NPR would amend the supervisory formula approach in a manner that results in higher risk weights for resecuritization positions. The proposed rule also would revise the definition of eligible financial collateral to exclude certain instruments that performed poorly during the crisis, such as resecuritization exposures.

Consistent with Section 939A of the Dodd-Frank Act, the proposed rule would remove the ratings-based and the internal assessment approaches from the securitization hierarchy under the existing advanced approaches rules and substitute in their place a simplified supervisory formula approach ("SSFA") (see the Standardized Approaches

[3] The proposed rule would define a resecuritization as a securitization in which one or more of the underlying exposures is a securitization exposure.

NPR for a more extensive discussion of the SSFA). The agencies are proposing to remove the internal assessment approaches because we believe the use of the SSFA will produce more consistent results.

Consistent with the BCBS Enhancements, the agencies are proposing certain other revisions to the securitization Framework under the advanced approaches rules. Specifically, the proposed rule would broaden the definition of securitization to include an exposure that directly or indirectly references a securitization exposure. In addition, consistent with the BCBS Enhancements, the NPR would improve risk-management practices with respect to securitization exposures by requiring banking organizations subject to the advanced approaches rules to conduct more rigorous credit analysis prior to acquiring such exposures. The NPR also would require enhanced disclosure requirements related to securitization exposures.

Other Revisions to Remove Credit Ratings

The agencies are proposing to replace creditworthiness standards in current definitions of the advanced approaches rules that reference credit ratings. (For example, under the current advanced approaches rules the term "eligible double default guarantor" requires the guarantor of an exposure to be of investment grade credit rating status). In general, the ratings-based standards would be replaced with a new "investment grade" standard, which would be defined as a determination by the bank that an entity to which the bank has exposure through a loan or security, or the reference entity with respect to a credit derivative, has adequate financial capacity to satisfy all commitments under the exposure for the projected life of the investment. Such an entity would have an adequate capacity to meet financial commitments if its risk of default is low and full and timely repayment of principal is expected.

In addition, the agencies are proposing to revise the collateral haircut approach by removing references to credit ratings from the matrix used to determine the standard supervisory market price volatility haircuts applicable to certain forms of collateral. Under the proposed rule, the market price volatility haircut would be based, in part, on the risk weight applicable to collateral under the Standardized Approaches NPR.

Market Risk Rule

Consistent with their new authorities under section 312 of the Dodd-Frank Act, the agencies are proposing to revise the agencies' market risk rules to apply to state and federal savings associations, as well as savings and loan holding companies. The Office of Thrift Supervision ("OTS") did not implement the market risk capital rules for such institutions prior to its abolition under section 313 of the Dodd-Frank Act because, as a general matter, such institutions do not engage in trading activity to a substantial degree. However, the agencies believe that any savings association or savings and loan holding company whose trading activity grows to the extent that it meets the thresholds should hold capital commensurate with the risk of the trading activity and should have in place the prudential risk management systems and processes required under the market risk capital rule. Therefore, the agencies believe it is necessary and appropriate to expand the scope of the market risk rule to apply to savings associations and savings and loan holding companies.

IV. Recommendation

Staff recommends that the Board approve for publication in the *Federal Register* the attached interagency NPR, which seeks comment on revisions to the advanced approaches rules and market risk rules of the FDIC, FRB, and OCC that are consistent with modifications to the BCBS amendments and the Dodd-Frank Act.

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