November 19, 2019

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director

SUBJECT: Regulatory Capital Rule: Standardized Approach for Calculating the Exposure Amount of Derivative Contracts

Summary: Staff are presenting for the approval of the Federal Deposit Insurance Corporation ("FDIC") Board of Directors ("FDIC Board") a request to publish the attached interagency final rule ("final rule") that would implement a new approach, titled the standardized approach for counterparty credit risk ("SA-CCR"), for calculating the exposure amount of derivative contracts under the regulatory capital rule ("capital rule") of the FDIC, the Board of Governors of the Federal Reserve System ("FRB"), and the Office of the Comptroller of the Currency ("OCC") (collectively, the "agencies"). The final rule replaces the current exposure methodology ("CEM") as an alternative method for purposes of calculating advanced approaches total risk-weighted assets under the capital rule. The final rule requires that banking organizations subject to the Category I and II standards ("Category I and II banking organizations") in the interagency tailoring final rule (84 *Federal Register* 59230) ("tailoring final rule") use SA-CCR to calculate their standardized total risk-weighted assets; all other banking organizations could elect to use either CEM or SA-CCR for purposes of calculating their standardized total risk-weighted assets.

The final rule updates other parts of the capital rule to account for the implementation of SA-CCR by: (1) requiring Category I and Category II banking organizations to use SA-CCR to

Concur:

Nicholas J. Podsiadly
General Counsel

determine the exposure amount of derivative contracts for purposes of total leverage exposure (the denominator of the supplementary leverage ratio); (2) incorporating SA-CCR into the cleared transaction framework under the capital rule; and (3) making other technical amendments with respect to cleared transactions. Category III banking organizations under the tailoring final rule are provided an option to use CEM or SA-CCR to determine the exposure amount of derivative contracts for total leverage exposure for the supplementary leverage ratio. If a Category III banking organization chooses to use CEM to calculate the total risk-weighted assets, it must use CEM to determine the exposure amount of derivative contracts for total leverage exposure.

There is only one FDIC-supervised institution (in Category I under the tailoring rule) that would be required under this final rule to apply SA-CCR.

The agencies received approximately 58 comments on the proposal from interested parties, including banking organizations, trade groups, members of Congress, and advocacy organizations.

Recommendation: FDIC staff are requesting the FDIC Board to approve this final rule and authorize its publication in the *Federal Register* with an effective date of April 1, 2020, and a mandatory compliance date of January 1, 2022, for advanced approaches banking organizations and Category III banking organizations under the tailoring final rule.

Discussion:

I. Background and Application of the Final Rule

This final rule adopts SA-CCR as a new methodology for calculating the exposure amount of derivative contracts under the capital rule that provides important improvements to risk-sensitivity and calibration relative to CEM, resulting in more appropriate capital

requirements for derivative contracts. The SA-CCR capital treatment for derivative contracts is more risk-sensitive than the CEM and less complex and model-dependent than the internal models methodology ("IMM") that could be used by advanced approaches banking organizations, subject to regulatory approval. This final rule is substantially compatible with international standards issued by the Basel Committee on Banking Supervision ("BCBS") regarding regulatory capital treatment for derivative contracts among internationally active banking organizations.

The final rule requires an advanced approaches banking organization to use SA-CCR to determine the exposure amount for a derivative contract for purposes of calculating its standardized total risk-weighted assets and total leverage exposure in the supplementary leverage ratio. The final rule requires that advanced approaches banking organizations implement SA-CCR by January 1, 2022.

The final rule also revises the advanced approaches in the capital rule by replacing CEM with SA-CCR. Therefore, an advanced approaches banking organization has the option to use SA-CCR or IMM to determine the exposure amount for a derivative contract. However, if an advanced approaches banking organization elects to use SA-CCR to determine the exposure amount for its non-cleared derivative contracts, it also would be required to use SA-CCR to determine the trade exposure amount for a cleared derivative contract. Requiring an advanced approaches banking organization to use either SA-CCR or IMM for all purposes under the advanced approaches will promote consistency within the capital rule and is operationally less complex than an approach that provides for optionality within the capital rule for both non-cleared and cleared derivative transactions. This feature of the final rule also facilitates

regulatory reporting and the supervisory assessment of a banking organization's capital management program.

Under the final rule, for non-advanced approaches banking organizations, SA-CCR is available as an option to CEM, because the implementation of SA-CCR requires internal systems enhancements and other operational modifications that could be costly and present additional burden. A non-advanced approaches banking organization that elects to use SA-CCR must use SA-CCR to determine the trade exposure amount for its cleared derivative contracts and for purposes of calculating the risk-weighted asset amount of the default fund contribution of a central counterparty ("CCP") or qualifying central counterparty ("QCCP").

The final rule contains a number of modifications of the proposed rule to address certain concerns raised by commenters. First, the final rule changes certain of the supervisory factors for commodity derivative contracts to coincide with the supervisory factors in the Basel Committee standard. Second, the final rule removes the alpha factor for exposures to commercial end-users. Third, the final rule allows a banking organization to treat settled-to-market derivative contracts as subject to a variation margin agreement, allowing such contracts to net with collateralized-to-market derivative contracts of the same netting set. The final rule allows clearing member banking organizations to recognize client collateral under the supplementary leverage ratio, to the same extent a banking organization may recognize collateral for risk-based capital purposes. Lastly, in order to capture the longer close-out period required in the event of a central counterparty failure, the final rule provides that MPOR cannot be less than ten business days for transactions subject to a variation margin agreement that are not client-facing derivative transactions.

II. Mechanics of SA-CCR

A. Netting Sets

Under SA-CCR, a banking organization calculates the exposure amount of its derivative contracts at the netting set level, meaning either one derivative contract between a banking organization and a single counterparty, or a group of derivative contracts between a banking organization and a single counterparty that are subject to a qualifying master netting agreement.

B. Hedging Sets

For purposes of the potential future exposure ("PFE") calculation under SA-CCR, a banking organization fully or partially nets within each hedging set, which are derivative contracts within the same netting set that share similar risk factors. The formula for arriving at PFE under SA-CCR of netted derivative contracts within a hedging set is particular to each hedging set type and would reflect different regulatory correlation assumptions between risk factors in the hedging sets.

C. Exposure Amount

Under SA-CCR, the exposure amount for a derivative contract is equal to an alpha factor of 1.4 multiplied by the sum of the replacement cost of the netting set and PFE of the netting set and is calibrated to produce exposures that are no lower than those amounts calculated using the IMM. For a derivative contract with a commercial end-user counterparty, the exposure amount is equal to the sum of the replacement cost of the netting set and PFE of the netting set.

D. Replacement Cost

Replacement cost generally is the cost of replacing a given contract if the banking organization's counterparty defaults. SA-CCR provides separate formulas for replacement cost depending on whether the counterparty to a banking organization is required to post variation

margin for a netting set.[1] In general, when a banking organization records a net positive amount of financial collateral, the replacement cost would be reduced. Conversely, when the banking organization records a net negative amount of financial collateral, the replacement cost would increase. A replacement cost calculation of a netting set subject to a variation margin requirement is designed to reflect the maximum possible unsecured exposure that would not trigger a variation margin call.

If the netting set is not subject to a variation margin requirement or the counterparty of the banking organization is not required to post variation margin, the replacement cost is the greater of (1) the sum of the fair values of the derivative contracts within the netting set, less the net independent collateral[2] amount applicable to the derivative contracts, or (2) zero. If the netting set is subject to a variation margin requirement such that the counterparty of the banking organization must post-variation margin, the replacement cost is generally the greater of (1) the sum of the fair values of the derivative contracts within the netting set, less the net independent collateral amount and the variation margin applicable to such derivative contracts; (2) the sum of the variation margin threshold and minimum transfer amount applicable to the derivative contracts within the netting set less the net independent collateral amount applicable to such derivative contracts; or (3) zero.

---

[1] For purposes of this final rule, variation margin means financial collateral that is subject to a collateral agreement provided by one party to its counterparty to meet the performance of the first party's obligations under one or more transactions between the parties as a result of a change in value of such obligations since the last time such financial collateral was provided.

[2] Independent collateral (also known as an initial margin) is defined generally as financial collateral, other than variation margin that is subject to a collateral agreement, or upon which the banking organization has a perfected, first-priority security interest or the legal equivalent thereof, the amount of which does not change directly in response to the value of the derivative contract or contracts that the financial collateral secures.

E. Aggregated Amount and Hedging Set Amounts

Under the final rule, the aggregated amount of the PFE for a netting set results from the product of the PFE multiplier and the sum of all hedging set amounts within the netting set. Hedging sets are determined by derivative contracts that share similar risk factors based on the following asset classes: interest rate, foreign exchange, credit, equity, and commodities. A banking organization then determines each hedging set amount using asset-class specific formulas that allow for full or partial netting.

F. PFE Multiplier

SA-CCR introduces the concept of a PFE multiplier, which allows a banking organization to reduce the PFE amount through recognition of overcollateralization and negative fair value amounts of the derivative contracts within a netting set. The PFE multiplier reduces the aggregated amount of PFE of a given derivative netting set by taking into account the amount of excess collateral available and negative fair value of the set. The PFE multiplier has a value of between 1 and 0.05 depending on the value of the financial collateral held compared to the net fair value of the derivative contract.

G. Adjusted Derivative Contract Amount

Under the final rule, a banking organization would calculate an adjusted derivative contract amount for each derivative contract prior to aggregating these amounts within a hedging set for purposes of calculating default exposure for counterparty credit risk, and therefore risk weighted assets for the capital rule. The adjusted derivative contract amount is intended to reflect a conservative estimate of the effective expected positive exposure[3] ("EEPE") of the

[3] The EEPE for a netting set is the time-weighted average of the effective expected exposure profile over a one-year horizon. Effective exposure is defined in the capital rule to mean

derivative contract based on supervisory-provided inputs and the risk horizon of the particular derivative contract, assuming zero market value and zero collateral. Specifically, a banking organization calculates the adjusted derivative contract amount as the adjusted notional amount of the derivative contract, multiplied by a supervisory factor, maturity factor, and supervisory delta. The adjusted notional amount generally specifies the size of the derivative contract. The supervisory factor converts the adjusted notional amount of the derivative contract into an EEPE based on the measured volatility specific to each asset class over a one-year horizon. The maturity factor scales down the one-year time horizon of the supervisory factor to the appropriate risk horizon of the derivative contract. The supervisory delta adjustment reflects the sensitivity of the derivative contract, scaled to unit size, to the underlying risk factor, including the direction of the derivative contract (positive or negative) with respect to the underlying risk factor.

III. Treatment of Default Fund Contribution to CCP/QCCP

The final rule simplifies the formula used to determine the risk-weighted asset amount for a CCP/QCCP's default fund contribution. The final rule provides for eventual elimination the current methods for advanced approach banking organization to determine the risk-weighted asset amount for its default fund contributions to a CCP or QCCP and implement a new and simpler method that would be based on the banking organization's *pro-rata* share of the CCP's or QCCP's default fund. However, the final rule allows banking organizations that elect to use SA-CCR to continue to use method 1 or method 2 in under CEM to calculate the risk-weighted asset amount for default fund contributions until January 1, 2022. This provision is intended to provide sufficient time for clearing member banking organizations to coordinate with QCCPs to

---

generally the expected value of the probability distribution of non-negative credit risk exposures to a counterparty at any specified future date before maturity date of the longest term transaction in the netting set.

obtain the hypothetical capital requirement produced under SA-CCR (or the requisite information to calculate it) from the CCPs, in order for such entities to qualify as QCCPs after the mandatory compliance date.

IV. Revisions to Supplementary Leverage Ratio

Under the capital rule, banking organizations in Category I, Category II, or Category III under the tailoring final rule are subject to a supplementary leverage ratio. A banking organization's supplementary leverage ratio is the ratio of its tier 1 capital to its total leverage exposure. Total leverage exposure includes both on-balance sheet assets and certain off-balance sheet exposures, including derivative contracts.

The final rule allows a clearing member banking organization to recognize the counterparty credit risk-reducing effect of client collateral in replacement cost and PFE for purposes of calculating total leverage exposure under certain circumstances. In particular, this treatment applies to a clearing member banking organization's exposure from its client-facing derivative transactions. For such an exposures, a clearing member banking organization would use SA-CCR, as applied for risk-based capital purposes, which permits recognition of both cash and non-cash forms of margin in the form of financial collateral received from a client to offset the replacement cost and PFE components for client-facing derivative transactions. Although there are some risks associated with CCPs, the agencies believe that central clearing through CCPs generally reduces the counterparty credit risk of derivative contracts through the multilateral netting of exposures, establishment and enforcement of collateral requirements, and promotion of market transparency. Also, this treatment is consistent with the G20 mandate to establish policies that support the use of central clearing, and recent developments by the Basel Committee.

V. Technical Amendments

The final rule makes certain technical corrections and clarifications to the capital rule to: (1) clarify that cash collateral posted by a clearing member banking organization to a QCCP, which could be considered a receivable under the accounting framework, would not be risk-weighted as a corporate exposure; (2) revise the definition of financial collateral to allow clearing members to recognize non-cash client collateral posted to a CCP as financial collateral; (3) permit a clearing member that does not guarantee a CCP's performance to the clearing member's client to apply a zero percent risk-weight to the CCP-facing portion of the exposure; (4) remove requirements in the capital rule that collateral posted by a clearing member client banking organization to a clearing member must be bankruptcy-remote from the custodian in order for the client bank to avoid the application of capital requirements for the collateral and clarify that a custodian must be acting in its capacity as a custodian for such capital treatment to apply; and (5) revise the capital rule to add an exception to the ten-day holding period for cleared derivative contracts, and apply a scaling factor to the standard haircuts (discounts) to reflect a five-day holding period.

Conclusion: FDIC staff are requesting the FDIC Board to approve the attached interagency final rule and authorize its publication in the Federal Register with an effective date of April 1, 2020.

Staff Contacts:

RMS/Capital Markets

Bobby Bean, Associate Director (ext. 8-6705)
Irina Leonova, Senior Policy Analyst (ext. 8-3843)
Peter Yen, Senior Policy Analyst (ext. 8-6568)

Legal

Michael Phillips, Counsel (ext. 8-3581)