BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: June 19, 2008

To: Board of Governors

From: Governor Kroszner

Subject: Notice of Proposed Rulemaking Implementing the Basel II Standardized Risk-Based Capital Framework in the United States

Attached are a memorandum to the Board and a draft Federal Register notice that present an interagency notice of proposed rulemaking (Basel II Standardized NPR). The proposal would provide an optional alternative to the agencies' Basel I-based risk-based capital rules that would enhance risk sensitivity without unduly increasing regulatory burden. Board staff seeks the Board's approval to issue the proposed rulemaking after all agencies complete their internal review procedures.

The Committee on Supervision and Regulatory Affairs has reviewed the proposal and I believe it is ready for the Board's consideration.

Attachment

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF BANKING SUPERVISION AND REGULATION

Date:	June 19, 2008
To:	Board of Governors of the Federal Reserve System
From:	Staff[1]
Subject:	Notice of Proposed Rulemaking Implementing the Basel II Standardized Risk-Based Capital Framework in the United States

ACTION REQUESTED

Board approval to issue for public comment a notice of proposed rulemaking (the standardized NPR) implementing a standardized risk-based capital framework based on the Basel Committee on Banking Supervision's (BCBS) revised capital accord. Staff also requests Board approval to make non-substantive edits to the proposal prior to its publication. If approved by the Board, the standardized NPR will be published jointly by the Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Office of Thrift Supervision (agencies) in the Federal Register after all of the agencies have completed their approval procedures. A draft of the standardized NPR is attached.

BACKGROUND

In the United States, banks, thrifts and bank holding companies (collectively referred to as banks or institutions) are subject to minimum regulatory capital requirements that include a minimum leverage ratio requirement as well as minimum risk-based ratio requirements.[2] The current applicable U.S. risk-based capital requirements (general risk-based capital rules) are based on an internationally agreed framework for capital measurement that was developed by the

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[2] The Board's capital rules may be found at 12 CFR part 208, Appendices A, B, and E (for state member banks) and 12 CFR part 225, Appendices A, D, and E (for bank holding companies).

BCBS and endorsed by the G-10 Governors in 1988.[3] This framework is referred to as Basel I. Basel I was intended to strengthen capital levels at large, internationally active banks and to foster international consistency through a common definition of capital and a common methodology for measuring capital relative to broad categories of risk. Basel I also reduced disincentives for banks to hold liquid, low-risk assets and factored off-balance sheet exposures into risk-based capital requirements, representing a significant step forward for regulatory capital measurement.

Since their implementation in 1989, Board staff has worked with the other U.S. banking agencies to make a number of revisions to the general risk-based capital rules -- not only to respond to changes in financial market practices and accounting standards, but also to implement legislative mandates and address safety and soundness issues. While the general risk-based capital rules have generally served their intended purposes well for some time, they nevertheless do not incorporate more recent innovations in financial products and services and improvements in risk measurement and management practices developed by the industry since the 1980s.

Although past revisions to the general risk-based capital rules have to some extent enhanced its risk sensitivity, more recently the agencies have limited modifications to the rules while international efforts to create a new risk-based capital framework were in process. This international effort led to the BCBS's adoption in June 2004 of a more risk-sensitive capital adequacy framework, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (New Accord or Basel II). Basel II encompasses three reinforcing pillars: minimum regulatory capital requirements (pillar 1), supervisory review (pillar 2), and market discipline through enhanced public disclosure (pillar 3).

[3] The BCBS was established by the central bank governors of the G-10 countries in 1975. Its members are senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

Under the first pillar, a bank must calculate risk-based capital requirements for exposures to credit risk and operational risk. Banks with significant trading activities also must factor in a measure for exposure to market risk.

For both credit risk and operational risk, Basel II provides several methodologies for determining risk-based capital requirements. For credit risk there is a standardized approach, essentially a set of modifications to the Basel I framework, and two internal ratings-based (IRB) approaches, which use an institution's internal estimates of key risk parameters for exposures in combination with specified risk-based capital formulas to derive capital requirements. The foundation IRB approach employs risk parameters that are provided partly by supervisors and partly by the institutions. The advanced IRB approach allows institutions to provide all of the risk parameters.

For operational risk, the New Accord provides three methodologies: the basic indicator approach, the standardized approach, and the advanced measurement approaches (AMA). Under the basic indicator and standardized approaches, capital requirements are fixed percentages of a bank's gross income. The AMA permits a bank to develop its individual approach for measuring and managing operational risk and determining the associated capital requirement, subject to supervisory oversight. Together, the advanced IRB approach for credit risk and the AMA for operational risk are referred to as the "advanced approaches."

The agencies issued in December 2007 a final rule implementing in the United States the advanced approaches under Basel II (advanced approaches final rule).[4] The advanced approaches final rule sets forth criteria for identifying "core banks" that are subject to the rule on a mandatory basis.[5] While core banks are required to adopt the advanced approaches, other

[4] 72 FR 69288 (December 7, 2007).

[5] A depository institution is a core bank if its consolidated total assets are $250 billion or more, its consolidated on-balance sheet foreign exposure is $10 billion or more, or it is a subsidiary of another depository institution or bank holding company that uses the advanced approaches final rule. A bank holding company is a core bank if its consolidated total assets (excluding assets held by an insurance underwriting subsidiary) are $250 billion or more, its

banks may voluntarily apply the advanced approaches, provided they can meet the applicable qualifying criteria. Banks that do not adopt the advanced approaches remain subject to the general risk-based capital rules.

The implementation of the advanced approaches final rule resulted in a bifurcated regulatory capital framework in the United States -- one risk-based capital rule for banks using the advanced approaches final rule (advanced approaches organizations), and another risk-based capital rule for banks that do not use the advanced approaches final rule (general banking organizations).

Since the agencies began the process of moving towards a bifurcated risk-based capital regime, general banking organizations have raised concern about potential competitive inequities that could arise if the agencies apply different risk-based capital rules to different banks. In addition, both the agencies and the industry recognized that some aspects of the general risk-based capital rules need updating. Thus, on December 26, 2006, the agencies issued a notice of proposed rulemaking (Basel IA NPR) that provided U.S. banks with a third alternative to the general risk-based capital rules and the advanced approaches framework. The Basel IA NPR sought to better align capital and risk while balancing operational feasibility and regulatory burden for banks not required to adopt the advanced approaches. It proposed certain modifications to the general risk-based capital rules with the objective of improving risk sensitivity while also addressing some disparities between banks that would be applying the advanced approaches final rule and those that would continue using the general risk-based capital rules. The risk-based capital regime proposed in the Basel IA NPR would have been optional for banks other than core banks.

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consolidated on-balance sheet foreign exposure is $10 billion or more, or it has a subsidiary depository institution that uses the advanced approaches.

In response to the Basel IA NPR, the agencies received 67 public comments from banking, trade, and other organizations and individuals. Most commenters on the Basel IA NPR supported the agencies' goal to make the capital rules more risk sensitive without adding undue regulatory burden. However, a substantial number of the commenters representing a broad range of banks and trade associations urged the agencies to implement the standardized approach as set forth in Basel II rather than continue with implementation of the Basel IA proposal. The commenters generally asserted that the standardized approach was more risk sensitive than the proposal in the Basel IA NPR and would more appropriately address the industry's competitive concerns, both domestically and internationally. Most commenters asserted that the modifications proposed in Basel IA affected too few asset classes and that the proposal would fall short of what the industry would need to remain competitive. These commenters noted that the standardized approach in Basel II, with its broader application across asset classes, more closely tracks the advanced approaches of Basel II, and would help to reduce competitive equity issues without imposing undue burden on the banks that would most likely adopt it. While few comments were received on the operational risk aspect of the standardized approach, most commenters on the issue believed that institutions should be given flexibility in choosing the operational risk framework best suited to their situation.

Most commenters supported the agencies' decision to make the proposed Basel IA framework optional, though some requested that banks be permitted to opt in to selected portions of the Basel IA framework without adopting the entire Basel IA framework. Some commenters also suggested that implementation of the Basel II standardized approach in the United States should be made available to all U.S. banks, including core banks.

After consideration of industry comments, the agencies decided not to finalize the Basel IA proposal. Staffs have instead developed the standardized NPR now under consideration that would implement the Basel II standardized approach for credit risk and the basic indicator approach for operational risk. The standardized NPR is generally consistent with the standardized approach and basic indicator approach as set forth in the New Accord. However, in a few places, the standardized NPR diverges from the New Accord to incorporate a more risk sensitive treatment, most notably in the approaches for residential mortgages and equity exposures.

The proposed rule is structured in seven broad parts. Part I explains the opt-in nature of the rule, provides key definitions, and sets forth the minimum risk-based capital ratios. Part II describes adjustments to the numerator. Parts III through VI set forth the applicable risk weights and describe the mechanics and qualification processes for using different aspects of the standardized framework. Part VII provides public disclosure requirements for banks using the standardized framework. This memorandum follows the structure of the standardized NPR preamble and identifies the pages in the attached preamble where more detailed discussion of the issues may be found.

DISCUSSION

Overview of the Proposed Rule

The standardized NPR is intended to produce risk-based capital requirements that are more risk-sensitive than the general risk-based capital rules. The primary difference between the proposed rule and the general risk-based capital rules is the methodology used for calculating the denominator of the risk-based ratios -- risk-weighted assets.

Broadly speaking, banks applying the proposed rule would determine risk-weighted-asset amounts for (1) general credit risk, (2) unsettled transactions, (3) securitization exposures, (4) equity exposures, and (5) operational risk. Total risk-weighted assets would be the sum of these five amounts. Banks using the market risk rule would continue to be subject to that rule and would factor their market risk-equivalent assets into their total risk-weighted assets. A bank's risk-based capital ratios are calculated by dividing its tier 1 and total qualifying capital by its total risk-weighted assets.

Banks would be required to assess their overall capital position relative to their total risk exposure and would be subject to supervisory review of their comprehensive capital adequacy (pillar 2). In this regard, total risk exposure would include exposure to interest rate, liquidity, funding, reputational, and market risks. Other factors would include the quality and level of earnings, concentrations, risks arising from nontraditional activities, the quality of loans and investments, and management's overall ability to monitor and control financial and operating risks. All banks using the standardized framework would continue to be subject to the applicable tier 1 leverage ratio requirements, and each depository institution (DI) would continue to be subject to the prompt corrective action thresholds. The proposal restates the agencies' supervisory authority to require a bank to hold an amount of capital greater than would be required under the proposed rule.

Scope of Application (Attachment 1 pages 47 - 52)

Any bank other than a core bank would have the choice of whether to opt in to the standardized framework (subject to prior notification of its primary Federal supervisor) or remain subject to the general risk-based capital rules. Generally, if a BHC or any subsidiary depository institution of a BHC were to opt in to the standardized framework, then all affiliated depository institutions and the parent company (as applicable) would also have to opt in. This approach is designed as a safeguard against regulatory capital arbitrage among affiliated banks. However, because there may be occasional situations where use of the standardized framework could create undue burden at an individual depository institution within a corporate family, the standardized framework includes a provision allowing a bank that would otherwise be required to apply the standardized framework to use the general risk-based capital rules instead, provided that its primary Federal supervisor determines in writing that the standardized framework is not appropriate for that bank. The proposal also generally authorizes the primary Federal supervisor of an institution to determine whether application of the standardized approach is appropriate for the institution in light of the institution's asset size, level of complexity, risk profile, or scope of operations.

Consistent with the general risk-based capital rules for BHCs, small BHCs with total consolidated assets under $500 million would be exempt from applying the standardized framework at the parent company level. In addition, a bank that opts to use the standardized framework could later choose to return to the general risk-based capital rules, but only after providing prior notification to its primary Federal supervisor. The notification would have to include an explanation of the bank's rationale for returning to the general risk-based capital rules.

Calculation of Tier 1 Capital and Total Qualifying Capital (Attachment 1 pages 53 - 57)

The proposed rule maintains the general risk-based capital rules' minimum tier 1 risk-based capital ratio of 4.0 percent and total risk-based capital ratio of 8.0 percent. Under the proposal, a bank's total qualifying capital would be the sum of its tier 1 capital elements and tier 2 capital elements, subject to various limits and restrictions, and minus certain deductions. The tier 1 and tier 2 capital elements remain the same as they are currently in the general risk-based capital rules.

A bank would continue to deduct from tier 1 capital goodwill, other intangible assets, and deferred tax assets to the same extent that these items are currently deducted under the general risk-based capital rules. Qualifying intangible assets and deferred tax assets that meet the conditions and limits in the general risk-based capital rules would not have to be deducted from tier 1 capital. In addition, a bank would not have to deduct from tier 1 capital a percentage of the adjusted carrying value of its nonfinancial equity investments as it does under the general risk-based capital rules. Instead, the bank's equity exposures would be subject to the equity treatment in section V of the proposed rule.

A bank also would have to deduct from tier 1 capital any after-tax gains-on-sale that arise from securitizations. Credit enhancing interest-only strips (CEIOs) and certain other low-rated or unrated securitization exposures would be deducted from tier 1 and tier 2 capital (50 percent from each category). In addition, under the proposal, a bank would deduct its exposures to certain unsettled and failed capital markets transactions 50 percent from tier 1 and 50 percent from tier 2 capital.

For BHCs with a regulated, consolidated insurance underwriting subsidiary, the BHC would consolidate the assets of that subsidiary for the purpose of determining risk-weighted assets, but would deduct from regulatory capital an amount equal to the subsidiary's minimum regulatory capital requirement as determined by its regulator. This approach is different from the New Accord, which broadly endorses a deconsolidation and deduction approach for insurance underwriting subsidiaries. Board staff believes a full deconsolidation and deduction approach may not fully capture the credit, market, and operational risk in insurance underwriting subsidiaries at the BHC level and, thus, has proposed the alternative approach outlined above. This alternative approach is consistent with the approach taken by the Board in the advanced approaches final rule.

Increase the Number of Risk Weight Categories

The standardized NPR proposes to increase the number of risk weight categories from the existing five risk weight categories of zero, 20, 50, 100, and 200 percent to a total of sixteen risk weight categories -- through the addition of risk weight categories of 10, 35, 75, 150, 300, 350, 400, 600, 625, 937.5, and 1250 percent.[6] The additional risk weight categories allow for greater

[6] Several of the proposed risk weights would only be used for limited types of exposures. For example, as discussed below, the 625, 937.5, and 1250 percent risk weights would only be used for certain unsettled or failed transactions.

differentiation across risk exposures without being overly complex or burdensome.

Use of External Ratings (Attachment 1 pages 60 - 66)

Under the general risk-based capital rules, only recourse obligations, direct credit substitutes, certain residual interests, and asset- and mortgage-backed securities may be risk-weighted based on an external rating -- a credit rating obtained from a nationally recognized statistical rating organization (NRSRO).[7]

The proposal expands the use of external ratings by using them to determine the risk-based capital requirement for exposures to sovereigns, public sector entities (PSEs), and banks, and for corporate exposures. In addition to the expanded use of external ratings for direct exposures, the proposal provides for an expanded range of recognized financial collateral and eligible guarantors based on external ratings.

It is staff's view that external ratings continue to be an important tool in measuring the level of risk of many exposures. External ratings can provide valuable information on the level of risk of exposures and provide a consistent and simple way to differentiate amongst them. In light of the recent market turmoil, however, the standardized NPR seeks comment on the advantages and disadvantages of using external ratings to set risk-based capital requirements for banks and on whether identified weaknesses in the credit rating process might warrant changes or enhancements to any aspect of the proposed standardized framework. Staff emphasizes that for any cases in which banks use third-party assessments of an exposure's risk, banks should also conduct their own due diligence of the risk of the exposure.

Under the proposal, a bank may risk weight an exposure based on the exposure's external rating or on an inferred rating. As a general matter, a bank may infer a rating for an exposure

[7] An NRSRO is an entity recognized by the Division of Market Regulation of the Securities and Exchange Commission (SEC) as an NRSRO for various purposes, including the SEC's uniform net capital requirements for brokers and dealers (17 CFR 240.15c3-1).

that has no external rating from (i) an issuer rating of the exposure's obligor or (ii) from the long-term external rating of another specific issue of the obligor that is not subordinated to the unrated exposure. Outside of the securitization framework, a bank would not be permitted to infer a rating from an exposure with a short-term external rating. Where applicable, a bank generally must use the lowest external or inferred rating of an exposure to determine its risk weight.

General Credit Exposures (Attachment 1 pages 67 - 89)

In the standardized NPR, general credit exposures are grouped into eight exposure categories. These include exposures to: (i) sovereign entities; (ii) supranational entities and multilateral development banks (MDBs); (iii) depository institutions, credit unions and foreign banks; (iv) PSEs (e.g., state and local governments); (v) corporate exposures; (vi) regulatory retail exposures; (vii) residential mortgage exposures; and (viii) pre-sold construction loans and statutory multifamily mortgages. The proposal assigns risk weights to exposures in some of these categories based on the applicable external or inferred rating of the exposure or, alternatively, the external rating of the collateral securing the exposure or of the guarantor of the exposure. The proposal uses other means to assign risk weights to exposures in other categories as described in more detail later in this memorandum.

Sovereign, PSE, and Corporate Exposures

Generally, under the proposed rule, a bank must risk weight exposures to sovereign entities, exposures to PSEs, and corporate exposures based on the applicable external or inferred rating of the exposure as set forth in Tables 1 – 4 below.[8] However, in no case may an exposure to a PSE or a corporate exposure receive a risk weight that is lower than the risk weight that corresponds to the lowest issuer rating of the PSE's or corporation's sovereign of incorporation.

[8] Under the standardized NPR, a bank may elect to risk weight all of its corporate exposures at 100 percent if it believes tracking external ratings of corporate exposures would be overly `burdensome.

The proposed rule's definition of a corporate exposure includes exposures to BHCs, securities firms, and government-sponsored entities (such as Fannie Mae and Freddie Mac) (GSEs).

Table 1 - Exposures to Sovereign Entities

Applicable external or applicable inferred rating for 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 investment grade	CCC	150
No applicable rating	N/A	100

Table 2 - 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
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

Table 3 - Corporate Exposures: Long-Term Credit Rating

Applicable external or applicable inferred rating	Example	Exposure 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

Table 4 - Corporate Exposures: Short-Term Credit Rating

Applicable external rating	Example	Exposure risk weight (in percent)
Highest investment grade	A-1/P-1	20
Second-highest investment grade	A-2/P-2	50
Third-highest investment grade	A-3/P-3	100
Below investment grade	B, C, and non-prime	150
No applicable external rating	NA	100

Under the general risk-based capital rules, the risk weight for sovereign exposures generally depends on whether the sovereign is a member of the Organization for Economic Cooperation and Development (OECD). Claims on an OECD sovereign central government receive a zero percent risk weight while most claims on other sovereign central governments receive a 100 percent risk weight. Under the general risk-based capital rules, the risk weight for all corporate loans and bonds generally is 100 percent. Accordingly, the standardized NPR's treatment of sovereign and corporate exposures should produce enhanced risk sensitivity for these asset classes.

Supranational Entities and MDBs

As proposed in the standardized NPR, exposures to certain supranational entities and MDBs would be assigned a zero percent risk weight based on their high credit quality, strong shareholder support, and shareholder structures comprised of a significant proportion of sovereign entities with high quality issuer ratings. As proposed, supranational entities would include the Bank for International Settlements, the International Monetary Fund, the European Central Bank and the European Commission. MDBs would include those multilateral lending institutions or regional development banks in which the U.S. government is a shareholder or contributing member or which the primary Federal supervisor determines pose comparable credit risk.

Exposures to U.S. and Foreign Banks

Under the proposal, an exposure to a U.S. depository institution, credit union, or foreign bank would be risk weighted based on the issuer rating of the entity's sovereign of incorporation. Generally, an exposure to a U.S. depository institution, credit union, or foreign bank would be risk weighted one risk-weight category less favorable than that assigned to a claim on the entity's sovereign. As a result, an exposure to a U.S. depository institution generally would be risk weighted at 20 percent under the standardized NPR (which is consistent with the general risk-based capital rules).

Regulatory Retail Exposures

Regulatory retail exposures generally include exposures to an individual or a business that do not exceed $1.0 million in aggregate exposure to any single obligor and are part of a well diversified portfolio. Such exposures would include credit card exposures and other consumer finance exposures, as well as many exposures to small businesses, but not residential mortgage exposures. Regulatory retail exposures would be assigned a risk weight of 75 percent, which is a decrease from 100 percent under the general risk-based capital rules. The lower proposed risk weight for regulatory retail exposures is consistent with the New Accord.

Residential Mortgage Exposures

The general risk-based capital rules assign first lien residential mortgages to either the 50 percent or 100 percent risk-weight category. To be eligible for the 50 percent category, a first lien mortgage must be owner-occupied or rented, prudently underwritten, not past due more than 90 days and performing in accordance with its original terms. Stand-alone junior lien residential mortgages are assigned a 100 percent risk weight.

The standardized NPR maintains the treatment for residential mortgages that was proposed in the Basel IA NPR. The standardized NPR defines a residential mortgage exposure as any exposure that is primarily secured by a first or junior lien on a one-to-four family property (including term loans and revolving home equity lines of credit). Consistent with the Basel IA proposal, the standardized NPR generally assigns prudently underwritten, owner-occupied or rented, first lien, one-to-four family residential mortgages that are not 90 days or more past due or on nonaccrual to a risk-weight category in Table 5 below based on their loan-to-value (LTV) ratios (after consideration of any loan-level private mortgage insurance (PMI)). The numerator of the ratio -- that is, the loan amount -- would include funded and unfunded amounts (including commitments such as lines of credit or the potential for negative amortization).

The standardized NPR proposes that a bank that holds both the first and subsequent liens, where there is no intervening lien, must combine the individual loan amounts to arrive at the appropriate risk-weight category set forth in Table 5 below. A first-lien residential mortgage exposure that has been restructured could not receive a risk weight lower than 100 percent unless the bank updates the LTV ratio at the time of the restructuring.

Table 5: Proposed Risk Weights for First Lien Mortgages

Loan-to-Value Ratio	Risk Weight
Up to 60%	20%
>60% and up to 80%	35%
>80% and up to 85%	50%
>85% and up to 90%	75%
>90% and up to 95%	100%
>95%	150%

A bank would assign a stand-alone junior lien residential mortgage exposure to the appropriate risk-weight category set forth in Table 6 below. The loan amount of the stand-alone junior lien would be combined with the loan amounts of all senior liens to calculate the LTV ratio.

Table 6: Proposed Risk Weights for Stand-Alone Junior Liens

Combined Loan to Value Ratio	Risk Weight
Up to 60%	75%
>60% and up to 90%	100%
>90%	150%

The denominator of the LTV ratio -- that is, the value of the property -- generally would be equal to the lesser of the acquisition cost of the property (for a purchase transaction) or the estimate of the property's value at the origination of the exposure (refinancing or junior lien transactions). All estimates of value would be based on an appraisal or evaluation of the property in conformance with the agencies' appraisal regulations.

Staff believes the standardized NPR's treatment for residential mortgages is more risk sensitive than the Basel II standardized approach, which assigns mortgages to either a 35 percent or 100 percent risk-weight category and does not provide a specific treatment for second lien mortgages.

Consistent with the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 (RTCRRI Act) and the general risk-based capital rules, a pre-sold construction loan would be subject to a 50 percent risk weight under the standardized NPR unless the purchase contract is cancelled. Such a loan with a cancelled contract would receive a 100 percent risk weight. Also consistent with the RTCRRI Act and the general risk-based capital rules, under the standardized NPR a statutory multifamily mortgage would receive a 50 percent risk weight. Multifamily mortgages not meeting the definition of a statutory multifamily mortgage would be treated as corporate exposures.

<u>Past Due and Nonaccrual Exposures</u>

Consistent with the New Accord, the standardized NPR would assign exposures that are more than 90 days past due or on nonaccrual a risk weight of 150 percent, except that mortgages meeting all of the qualifying criteria for a first-lien residential mortgage exposure and that have an LTV ratio of less than or equal to 90 percent would receive a risk weight of 100 percent. The risk weights of past due and nonacrrual exposures could be reduced to reflect the risk-mitigating impact of collateral and eligible guarantees.

<u>Off-Balance Sheet Items and OTC Derivatives (Attachment 1 pages 89 - 97)</u>

Consistent with the general risk-based capital rules, an off-balance sheet exposure would be converted to an on-balance sheet credit equivalent amount using a credit conversion factor (CCF). Under the standardized NPR, most CCFs would remain the same as in the general risk-based capital rules. Certain exposures, however, would receive a higher CCF than currently applies. These include: (i) an increase from a zero percent CCF to a 20 percent CCF for short-term commitments that are not unconditionally cancellable, (ii) an increase from a 10 percent CCF to a 20 percent CCF for eligible asset-backed commercial paper (ABCP) liquidity facilities, and (iii) an increase from a zero percent CCF to a 100 percent CCF for certain off-balance sheet securities financing transactions. Staff believes the higher CCFs would better reflect the credit risk associated with these exposures. Additionally, staff believes the inclusion of a CCF for certain off-balance sheet securities financing transactions addresses a problem area in the general risk-based capital rules, but maintains a low capital requirement for such transactions to the extent that they are secured by high quality collateral.

Credit Risk Mitigation for General Credit Exposures (Attachment 1 pages 97 - 124)

Collateral

The general risk-based capital rules recognize limited types of collateral: cash on deposit; securities issued or guaranteed by central governments of the OECD countries; securities issued or guaranteed by the U.S. government or its agencies; and securities issued by certain MDBs.

Under the standardized NPR, a bank would be able to recognize the risk-mitigating effects of a broader range of collateral referred to as financial collateral. Financial collateral includes collateral in the form of 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 residential mortgage exposures.

A bank would be permitted to recognize the risk-mitigating effects of financial collateral using one of three approaches: the simple approach, the collateral haircut approach, or the simple

VaR approach. The standardized NPR proposes to permit a bank to use any of these three approaches to recognize collateral provided the bank uses the same approach for all similar exposures. The collateral haircut and simple VaR approaches are the same as provided for in the advanced approaches final rule.

Simple Approach

Under the simple approach, a bank would substitute the risk weight of the collateral for the risk weight of the exposure for that portion of the exposure covered by collateral. Subject to certain exceptions, the risk weight assigned to the collateralized portion of the exposure under the simple approach could not be less than 20 percent.

Collateral Haircut Approach

The proposal would permit a bank to use the collateral haircut approach to recognize the risk mitigating effect of financial collateral that secures a repo-style transaction (e.g., a repurchase agreement, reverse repurchase agreement, or securities lending or borrowing transaction), eligible margin loan, collateralized over-the-counter (OTC) derivative contract, or single-product netting set of such transactions, through an adjustment to the exposure amount. Under the collateral haircut approach, a bank would calculate the exposure amount for a transaction or netting set by adding the following: (i) the value of the exposure less the value of the collateral; (ii) the net position in a given security multiplied by the market price volatility haircut appropriate to that security; and (iii) the net position of both cash and securities in each currency that is different from the settlement currency, multiplied by a haircut appropriate to each currency mismatch. To determine the appropriate haircuts, a bank could use standard supervisory haircuts or its own estimates of haircuts. Use of own-estimates haircuts would be subject to prior written approval by the bank's primary Federal supervisor and would need to reflect certain minimum qualitative and quantitative standards. The risk weight for a collateralized transaction whose exposure amount is calculated under the collateral haircut approach would be the risk weight appropriate for an unsecured claim on the counterparty (or the risk weight appropriate for any guarantees, if applicable).

Simple VaR Approach

With prior written supervisory approval, a bank would be able to use the simple VaR approach for single-product netting sets of repo-style transactions and eligible margin loans that are subject to a qualifying master netting agreement. Under the simple VaR approach, a bank's exposure amount on a given netting set would be equal to the value of the exposure minus the value of the collateral plus a VaR-based estimate of the potential future exposure (PFE), that is, the maximum exposure expected to occur on a future date with a high level of confidence. The VaR model would have to meet certain estimation and holding period requirements and would be subject to regular backtesting. The risk weight for a collateralized transaction whose exposure amount is calculated under the simple VaR approach would be the risk weight appropriate for an unsecured claim on the counterparty (or the risk weight appropriate for any guarantees, if applicable).

Guarantees and Credit Derivatives

The general risk-based capital rules generally recognize third-party guarantees provided only by 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. The standardized proposal expands the list of eligible guarantors to include any sovereign entity, a number of supranational entities and MDBs, a Federal Home Loan Bank and Farmer Mac, depository institutions, foreign banks and credit unions, bank holding companies and savings and loan holding companies, and, most notably, 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. Eligible guarantees must be in writing, unconditional, non-cancellable by and legally enforceable against the protection provider, and must give the beneficiary a direct claim against the protection provider. Eligible credit derivatives must meet all the requirements of an eligible guarantee, must be in the form of a credit default swap, nth-to-default swap, or total return swap and must meet a variety of additional eligibility requirements.

The proposal would allow a bank to recognize the credit risk mitigation benefits of an eligible guarantee or eligible credit derivative by substituting the risk weight associated with the eligible guarantee or eligible credit derivative for the risk weight assigned to the underlying exposure. The credit risk mitigation benefits of the guarantee or credit derivative would be reduced to reflect any maturity mismatch, lack of restructuring coverage, and currency mismatch. This substitution methodology is broadly consistent with that used in the general risk-based capital rules, but would allow for a much broader range of guarantors and a broader range of risk weights based on the external ratings of the guarantors.

Unsettled and Failed Securities, Foreign Exchange and Commodity Transactions (Attachment 1 pages 124 - 127)

Consistent with the advanced approaches final rule, the proposed rule sets forth risk-based capital requirements for unsettled and failed securities, foreign exchange, and commodities transactions. The proposal has different treatments for delivery-versus-payment (DvP) and payment-versus-payment (PvP) transactions with a normal settlement period, and non-DvP/non-PvP transactions with a normal settlement period. DvP transactions are those in which the buyer must make payment only if the seller has made delivery of the securities or commodities and vice versa. A PvP transaction is a foreign exchange transaction in which one party must make a final transfer of currencies only if the other party has made a final transfer of currencies. A normal settlement period is one that is equal to or less than the market standard for the underlying instrument and equal to or less than five business days.

For DvP or PvP transactions with a normal settlement period, if the bank's counterparty has not made payment or delivery within five business days after the settlement date, the bank would determine its risk-weighted asset amount by multiplying the positive current market value of the transaction by a risk weight that is a function of the number of days the settlement is past due. Risk weights applicable to unsettled transactions include 100, 625, 937.5, and 1,250 percent, depending on the number of business days after the contractual settlement date. For non-DvP/non-PvP transactions with a normal settlement period, a bank would have to hold risk-based capital if the bank has made a delivery to its counterparty, but has not received its corresponding deliverables by the end of the same business day. Until five business days after the deliverable is due, the risk-based capital requirement would equal the product of the current market value of the deliverable owed to the bank and the risk weight appropriate for an exposure to the counterparty. Thereafter, the current market value of the deliverable would be deducted 50 percent from tier 1 and 50 percent from tier 2 capital.

Securitization Exposures (Attachment 1 pages 127 - 157)

Securitization exposures include on-balance sheet and off-balance sheet credit exposures that arise from a traditional or synthetic securitization. A securitization transaction generally is one in which: (i) all or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties; (ii) the credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority; (iii) performance of the securitization exposure depends on the performance of the underlying exposures; and (iv) all or substantially all of the underlying exposures are financial assets. Thus, exposures resulting from the tranching of the risks of nonfinancial assets (such as project finance) generally would be treated under the general credit exposure rules, rather than the securitization rules.

Under the standardized NPR, a bank would determine the risk-based capital requirement for a qualifying securitization exposure using the Ratings-Based Approach (RBA). Otherwise, the bank would deduct the exposure from regulatory capital, with limited exceptions.

Specifically, to determine the risk-based capital requirement for a securitization exposure, a bank would apply the following hierarchy. First, as noted above, a bank would deduct from tier 1 and tier 2 capital any after-tax gains-on sale and CEIOs. Second, if an exposure has an external rating or has an inferred rating (that is, the exposure is senior to another securitization exposure in the transaction that has an external rating), the exposure generally would be subject to the RBA. If a securitization exposure does not qualify for the RBA but is either a senior securitization exposure, an exposure in a second loss position or better in an ABCP program, or an eligible ABCP liquidity facility, the bank would look through to the underlying assets to determine the appropriate risk weight for the exposure. Otherwise, a securitization exposure that does not qualify for the RBA would be deducted from regulatory capital.

The proposed treatment for securitization exposures is generally consistent with the general risk-based capital rules -- under both frameworks, exposures not subject to a ratings-based approach generally require dollar-for-dollar risk-based capital. However, the proposal is more straightforward than the general risk-based capital rules in that it provides a unified definition of and treatment for all securitization exposures. The proposed rule also requires certain securitization exposures to be deducted from tier 1 and tier 2 capital: in contrast, under the general risk-based capital rules, the dollar-for-dollar capital requirement is reflected in risk-weighted assets rather than in capital deductions. In addition, unlike the general risk-based capital rules, the proposed rule incorporates a capital requirement to address the risk of early amortization in securitizations of revolving credit facilities (discussed below). Moreover, the proposal would increase the capital requirement for short-term eligible ABCP liquidity facilities relative to the general risk-based capital rules by increasing the CCF on such exposures from

10 percent to 20 percent and by looking through to the highest risk weight within the pool of underlying assets to which the liquidity facility is exposed rather than to the weighted average risk weight of the underlying assets.

Staff notes that the BCBS has committed to reassess the Basel II framework in light of recent market events. The BCBS is, among other things, revisiting the capital treatments for re-securitizations, liquidity facilities to ABCP conduits, and securitization exposures in the trading book. Staff supports this effort and would expect to incorporate relevant findings in both the advanced approaches final rule and the standardized framework.

Consistent with current Federal Reserve policy, the standardized NPR provides that if a bank provides support to a securitization exposure in excess of the bank's predetermined contractual obligation, it would have to hold regulatory capital against all of the underlying exposures associated with the securitization as if the exposures had not been securitized and would have to deduct from tier 1 capital any after-tax gain-on-sale resulting from the securitization. In addition, the bank would have to publicly disclose that it has provided such implicit support and the regulatory impact to the bank of providing such support.

Ratings-Based Approach (RBA)

Under the RBA, a bank would determine the risk-weighted asset amount for a securitization exposure by multiplying the amount of the exposure by a supervisory risk weight that depends on the applicable external or inferred rating of the exposure. An originating bank would have to use the RBA if its retained securitization exposure has at least two external ratings or an inferred rating based on at least two external ratings; an investing bank must use the RBA if its securitization exposure has one or more external or inferred ratings. Although this two-rating requirement is not included in the New Accord, it is generally consistent with the treatment of originating and investing banks in the general risk-based capital and advanced approaches rules. Board staff believes that the market discipline evidenced by a third party purchasing a securitization exposure obviates the need for a second rating for an investing bank.

The assigned risk weights under the RBA range from 20 percent for AAA-rated exposures to 350 percent for exposures rated one category below investment grade as set forth in Tables 7 and 8 below. The proposal would also require a bank to deduct from regulatory capital any securitization exposure with an external or inferred rating two or more categories below investment grade for long-term ratings or below investment grade for short-term ratings.

Table 7 - Long-Term Credit Rating Risk Weights under the RBA

Applicable external rating or applicable inferred rating of a securitization 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	350
Two categories below investment grade	B	Deduction
Three categories or more below investment grade	CCC	Deduction

Table 8 - Short-Term Credit Rating Risk Weights under the RBA

Applicable external or applicable inferred rating of a securitization 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
Lowest investment grade rating	A-3/P-3	100
All other ratings	N/A	Deduction

As a general matter, other than the new 350 percent risk weight category for securitization exposures that are externally rated one category below investment grade, the risk-based capital requirements for externally rated securitization exposures in the standardized NPR are the same as the risk-based capital requirements for such exposures under the general risk-based capital rules.

Early Amortization Provisions

Under the proposed rule, an early amortization provision is defined as a provision that, when triggered, causes investors in the securitization to be repaid before the stated maturity of the securitization exposures, unless the provision is triggered solely by events not related to the performance of the underlying exposures or the originating bank (such as material changes in tax laws or regulations). An originating bank would have to hold risk-based capital against the investors' interest in a revolving securitization that contains an early amortization provision. The investors' interest would include both the drawn and undrawn lines of the underlying exposures that are allocated to the investers in the securitization.

The capital requirements vary depending on whether the amortization is controlled or non-controlled, whether the underlying exposures are revolving retail credit facilities that are uncommitted (for example, credit cards) or other revolving facilities, and the level of the three-month average excess spread for the securitization relative to the point at which the bank is required to trap excess spread under the securitization transaction. The treatment for early amortization provisions is consistent with the treatment for early amortization provisions in the advanced approaches final rule.

Equities (Attachment 1 pages 157 - 169)

Under the proposal, equity exposures generally would include a security or instrument that represents a direct or indirect ownership interest in, and residual claim on, the assets and income of a company; a security or instrument that is mandatorily convertible into an equity exposure; an option or warrant that is exercisable for an equity exposure; and any other security or instrument (other than a securitization exposure) to the extent that its return is based on the performance of an equity exposure.

A bank would use the simple risk-weight approach (SRWA) for equity exposures that are not exposures to an investment fund. Under the SRWA, a bank would generally assign a 300 percent risk weight to publicly traded equity exposures and a 400 percent risk weight to non-publicly traded equity exposures. Equity investments in leveraged investment firms (such as hedge funds and private equity funds) generally would be assigned a 600 percent risk weight. Equity exposures to non-leveraged investment funds generally would be assigned risk weights using a look-through approach to the underlying assets of the fund. Certain equity exposures to sovereigns, multilateral institutions, and public sector entities would have a risk weight of zero or 20 percent, and certain community development equity investments, hedged equity exposures, and non-significant equity investments up to certain limits would be eligible for a 100 percent risk weight.

Operational Risk (Attachment 1 pages 169 - 173)

For operational risk, the standardized NPR proposes that a bank use the basic indicator approach. Under the basic indicator approach, risk-weighted assets for operational risk equal 15 percent of the average positive annual gross income computed over the previous three years multiplied by 12.5. This calculation would exclude any years where gross income was zero or negative.

The standardized NPR does not propose allowing banks to use the Basel II standardized approach to operational risk nor the advanced measurements approaches, but asks whether it would be appropriate to include the AMA in a final rule and whether banks that could opt into the standardized framework believe they could meet AMA modeling requirements.

Supervisory Oversight and Internal Capital Adequacy Assessment (Attachment 1 pages 173 - 174)

One of the objectives of the proposed Basel II standardized approach beyond mandating minimum regulatory capital requirements is to provide incentives for banks to develop and apply better techniques for measuring and managing risks and ensuring that capital is adequate to support those risks. Consistent with current supervisory practices, under the standardized NPR, banks would be required to hold capital commensurate with the level and nature of all risks to which they are exposed, and to have in place a rigorous process for assessing their overall capital adequacy in relation to their risk profile and a comprehensive strategy for maintaining appropriate capital levels. A bank's primary Federal supervisor would evaluate a bank's compliance with the minimum capital requirements and evaluate how well the bank is assessing its capital needs relative to the risks to which the bank is exposed and its stated capital goals.

Disclosure (Attachment 1 pages 174 - 181)

Pillar 3 of the New Accord complements the risk-based capital requirements and the supervisory review process by encouraging market discipline through enhanced public disclosure. The public disclosure requirements are intended to allow market participants to assess key information about an institution's risk profile and its associated level of capital. Some of the disclosure requirements would be new for banks opting into the standardized framework. Nonetheless, staff believes that a number of the disclosures are already required by or are consistent with existing GAAP, SEC disclosure requirements, or regulatory reporting requirements.

The public disclosure requirements would apply to the top-tier legal entity within a consolidated group. In general, a DI that is a subsidiary of a BHC or of another DI would not be subject to the public disclosure requirements, except that every DI would have to disclose its total and tier 1 risk-based capital ratios and their components, similar to current requirements. Each bank that is subject to the disclosure requirements would be expected to have a formal disclosure policy that addresses the institution's approach for determining the disclosures it makes. Quantitative disclosures would be required quarterly and qualitative disclosures would be required annually. Significant changes to either would have to be disclosed in the interim.

The public disclosure requirements are comprised of 10 tables that provide the following information. Scope of application disclosures include a description of the level of the organization to which the disclosures apply and an outline of any differences in consolidation for accounting and regulatory capital purposes, as well as a description of any restrictions on the transfer of funds and capital within the organization. Capital structure disclosures provide information on various components of regulatory capital. Capital adequacy disclosures provide information about how a bank assesses the overall adequacy of its capital and requires the bank to disclose minimum capital requirements and ratios. Credit risk disclosures provide information on the different types and concentrations of credit risk to which a bank is exposed and the techniques the bank uses to measure, monitor, and mitigate those risks. Disclosures also cover securitization, operational risk, equities and interest rate risk in non-trading activities.

RECOMMENDATION:

For the past two years staff has engaged in ongoing dialogue with the industry and other interested parties on developments related to either the Basel IA NPR or this proposal. Staff believes that it is important at this time to receive further input from the public and the banking industry on the U.S. proposed implementation of the Basel II standardized approach. Thus, staff recommends that the Board approve the issuance of the attached standardized NPR for publication in the Federal Register after all agencies have finished their internal approval procedures.

Attachment