SUBJECT: Excluding Non-material Portfolios of Exposures from the Advanced Approaches (“Exclusion Treatment”)

Background

The advanced approaches risk-based capital rule\(^1\) (rule) provides a simplified method of calculating risk-weighted assets for non-material portfolios of exposures:

*Section 21(b)(1)(ii) Implementation plan*
[A bank or bank holding company’s implementation] plan must justify and support any proposed temporary or permanent exclusion of business lines, portfolios, or exposures from application of the advanced approaches in this appendix (which business lines, portfolios, and exposures must be, in the aggregate, immaterial to the bank or bank holding company).

*Section 31(e)(4) Non-material portfolios of exposures*
The risk-weighted asset amount of a portfolio of exposures for which the bank or bank holding company has demonstrated to the Federal Reserve’s satisfaction that the portfolio (when combined with all other portfolios of exposures that the bank or bank holding company seeks to treat under this paragraph) is not material to the bank or bank holding company is the sum of the carrying values of on-balance sheet exposures plus the notional amounts of off-balance sheet exposures in the portfolio. For purposes of this paragraph [31](e)(4), the notional amount of an over the counter (“OTC”) derivative contract that is not a credit derivative is the exposure at default (“EAD”) of the derivative as calculated in section 32 of this appendix.

The intent of sections 21(b)(1)(ii) and 31(e)(4) is to provide limited flexibility for banks and bank holding companies (referred to hereafter as “banking organizations”) to calculate risk-weighted assets in a potentially less burdensome manner when other approaches under the rule would be unduly difficult or costly to implement and the overall amount of exposures subject to this treatment is not material. Furthermore, the rule’s broader objectives require that the

\(^1\)12 CFR part 208, appendix F, and 12 CFR part 225, appendix G.
exclusion treatment not be used to avoid relatively high capital charges against higher risk exposures (referred to as “cherry picking”). When reviewing a banking organization’s application of this treatment, examiners should evaluate materiality within the context of the excluded exposures’ overall risk in relation to the banking organization’s capital.

This document sets forth criteria that should be used when determining whether the portfolios subject to this exclusion treatment are not material in the aggregate.

**General Implementation Guidance**

A banking organization must demonstrate to the satisfaction of the Federal Reserve that the portfolios should be treated under section 31(e)(4) of the rule as not material. The types of factors that the Federal Reserve would consider in making such determination include the following for each portfolio:

- The specific reason(s) for requesting treatment under section 31(e)(4);
- The historical and current size and anticipated growth of the portfolio over the next several years;
- Whether treatment under section 31(e)(4) would be permanent or temporary and, if the latter, the banking organization’s timeline for phasing out this treatment and its progress in meeting this timeline; and
- The risk presented by the portfolio, measured under various criteria (for example, recent loss performance, “best efforts” attempt to apply the requirements of the advanced approaches, and stress scenario based loss forecasting).

In addition, all excluded portfolios, in aggregate, must not be material to the banking organization. The remainder of this document sets forth two alternative, explicit criteria that may be used to demonstrate that portfolios are not material to the banking organization in the aggregate. If neither of the criterion is satisfied when a banking organization calculates its risk-weighted assets under section 31(e)(4) each quarter, the banking organization must otherwise demonstrate to the satisfaction of the Federal Reserve that the portfolios should be treated under section 31(e)(4) of the rule as not material. A banking organization should be able to demonstrate its compliance with this requirement on an ongoing basis.

The alternatives provide different thresholds for non-materiality depending on whether the aggregate risk-weighted asset amount calculated under section 31(e)(4) is less than the risk-weighted asset amount produced using other approaches permitted by the rule. When the banking organization can provide such analyses on an ongoing basis, a higher aggregate exposure amount may be treated as not material to the banking organization.
**Criterion 1:** A banking organization’s portfolios may be treated as not material in the aggregate for purposes of sections 21(b)(1)(ii) and 31(e)(4) of the rule if:

(a) The carrying values plus notional amounts of off-balance sheet amounts (or EAD amounts for OTC derivatives that are not credit derivatives) associated with these exposures in the aggregate is not greater than 20 percent of the banking organization’s tier 1 capital (as reported on the Risk-Based Capital Reporting for Institutions Subject to the Advanced Capital Adequacy Framework -- FFIEC 101 reporting form\(^2\)); and

(b) The banking organization demonstrates to the satisfaction of the Federal Reserve that the aggregate risk-weighted asset amount for these exposures would be greater than or equal to the amount produced using other approaches permitted by the rule for these portfolios, applying reasonable and conservative assumptions for any required element of the rule that the banking organization cannot readily or reliably determine.

Taken as whole, criterion 1 is intended to provide banking organizations the flexibility to not fully apply the advanced approaches for a limited set of portfolios while ensuring that the exclusion treatment is not used systematically to avoid higher risk weights otherwise required under the advanced approaches. With regard to paragraph (b) of criterion 1, a banking organization is expected to make a “best efforts” attempt to estimate what its risk-weighted assets would be under the advanced approaches, applying reasonable and conservative assumptions when it cannot readily apply the rule or meet the associated operational standards. If a banking organization is unable to establish that its portfolios satisfy condition (b) in criterion 1, criterion 2 establishes a separate threshold the banking organization could use to demonstrate that all excluded portfolios, in the aggregate, are not material to the banking organization.

**Criterion 2:** If a banking organization is unable to satisfy criterion 1, its portfolios nonetheless may be considered not material in the aggregate for purposes of sections 21(b)(1)(ii) and 31(e)(4) of the rule if the carrying values plus notional amounts of off-balance sheet amounts (or EAD amounts for OTC derivatives that are not credit derivatives) associated with these exposures in the aggregate is not greater than 5 percent of the banking organization’s tier 1 capital (as reported on the FFIEC 101 reporting form\(^2\)).

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\(^2\) Refer to the FFIEC website at [www.ffiec.gov](http://www.ffiec.gov) for the FFIEC 101 reporting form.