

## **Frequently Asked Questions on the Regulatory Capital Rule**

**April 6, 2015**

Staffs of the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board (Board), and the Federal Deposit Insurance Corporation (FDIC) (jointly, the agencies) have assembled the following frequently asked questions (FAQ) to clarify and answer questions regarding the 2013 “regulatory capital rule.”<sup>1</sup>

These FAQs represent the staffs’ response based on the application of the regulatory capital rule to the facts and circumstances presented. These FAQs do not represent new rules or regulations.

For purposes of these FAQs, section numbers refer to the agencies’ common regulatory capital rule. As an example, section 22 refers to 12 CFR 3.22 for OCC-supervised institutions, 12 CFR 217.22 for Board-supervised institutions, and 12 CFR 324.22 for FDIC-supervised institutions.

For the purpose of these FAQs, the term “general risk-based capital rules” refers to the risk-based capital rules located at 12 CFR part 3, appendix A and 12 CFR part 167 (OCC); 12 CFR part 208 and 12 CFR part 225, appendix A (Board); and 12 CFR part 325, appendix A, and 12 CFR part 390, subpart Z (FDIC). As of January 1, 2015, the general risk-based capital rules are no longer effective and are replaced by subparts A, B, C, and D of the regulatory capital rule.

Most of these FAQs address the agencies’ generally applicable capital rules, although most banks will find that not all of the topics are applicable. FAQs that are relevant only for advanced approaches banking organizations are marked with an asterisk (\*).

### **Definition of Capital**

**1. If an instrument with a step-up feature was includable in tier 2 capital under the general risk-based capital rules, and otherwise meets all other criteria for tier 2 capital instruments in the regulatory capital rule, and the instrument is not called on the step-up date, may the instrument be included in tier 2 capital under the regulatory capital rule?**<sup>2</sup>

Such instruments with step-up features that were included in tier 2 capital prior to May 19, 2010, by a depository institution holding company that are not eligible for grandfathering (under section 300(c)), or prior to September 12, 2010, by a depository institution, are subject to the phase-out provisions for non-qualifying capital instruments under section 300(c) of the

---

<sup>1</sup> See 78 Fed. Reg. 62018 (October 11, 2013) (OCC and Board) and 79 Fed. Reg. 20754 (April 14, 2014) (FDIC). The regulatory capital rule is codified at 12 CFR part 3 (OCC); 12 CFR part 217 (Board); and 12 CFR part 324 (FDIC).

<sup>2</sup> This FAQ assumes that the instrument was not issued under the Small Business Jobs Act of 2010 or prior to October 4, 2010, under the Emergency Economic Stabilization Act of 2008.

regulatory capital rule. However, if such an instrument remains outstanding once its interest rate has been “stepped-up,” and the instrument meets all other criteria for tier 2 capital instruments under the regulatory capital rule, it may be included in tier 2 capital since the instrument no longer has any terms or features that create an incentive for the issuer to redeem the instrument prior to maturity.

**2. If an instrument that was includable in tier 2 capital under the general risk-based capital rule has a call date that is associated with a step-up in the distant future, may that call date be considered the maturity date in order to avoid having the instrument subject to the phase-out provisions of the regulatory capital rule?<sup>3</sup>**

No, the step-up date is not a factor in determining the maturity date. The regulatory capital rule prohibits any feature in tier 2 capital instruments that would create significant incentives to redeem such instruments prior to maturity (see section 20(d)(1)(iv) of the regulatory capital rule). Thus, if the instrument has a significant incentive to redeem and was issued and included in tier 2 capital prior to May 19, 2010, by a depository institution holding company not eligible for grandfathering (under section 300(c)), or prior to September 12, 2010, by a depository institution, the instrument is subject to the phase-out provisions in section 300(c) of the regulatory capital rule. If the instrument was issued after those dates, it may not be included in regulatory capital.

**3. Is the regulatory capital amortization schedule for tier 2 capital instruments outlined in section 20(d)(1)(iv) considered a “significant incentive” to redeem?**

No. The amortization schedule is not considered a significant incentive to redeem. The amortization schedule is not a term or feature of the instrument but a regulatory requirement.

**4. Can convertible instruments be included in regulatory capital even if they are convertible less than five years after issuance?**

Convertibility of a capital instrument within five years of issuance does not preclude its qualification as regulatory capital if the instrument is convertible into a capital instrument of a higher quality (see section 20(d)(1)(iv), note 12 of the Board’s and OCC’s regulatory capital rule and footnote 13 of the FDIC’s regulatory capital rule). For example, a non-common stock additional tier 1 or tier 2 capital instrument that converts into common stock can be included in additional tier 1 capital or tier 2 capital (as appropriate), even if the contractual conversion date requires conversion less than five years after issuance, so long as the instrument meets all the relevant eligibility criteria in the regulatory capital rule.

**5. Are investments in the capital of Federal Reserve Banks and Federal Home Loan Banks (FHLB) in the form of common stock considered investments in the capital of unconsolidated financial institutions that would be subject to the regulatory capital rule’s 10 percent common equity tier 1 capital deduction threshold?**

No. The relevant definitions in section 2 of the regulatory capital rule exclude investments in sovereigns (sovereigns include central banks as well as Federal Reserve districts) and government sponsored enterprises (which include FHLBs). See section 2 of the regulatory capital rule.

---

<sup>3</sup> This FAQ assumes that the instrument was not issued under the Small Business Jobs Act of 2010 or prior to October 4, 2010, under the Emergency Economic Stabilization Act of 2008.

**6. Should banking organizations risk weight mortgage servicing assets (MSA) and significant investments in the capital of unconsolidated financial institutions that are not deducted from capital on a gross (pre-tax) basis, or should they risk weight such assets net of associated deferred tax liabilities?**

These assets are subject to risk weighting on a gross (pre-tax) basis. The ability to net associated deferred tax liabilities against deductible assets is only applicable for purposes of calculating the amount of the assets that must be deducted, not for purposes of calculating the risk weighted amount of such assets.

**7. Are foreign currency translation adjustments and accumulated net gains/losses on cash flow hedges related to the hedging of items that are not fair-valued on the balance sheet (which are components of accumulated other comprehensive income (AOCI)) subject to the transitional provisions in the regulatory capital rule?**

No. Consistent with the general risk-based capital rules, under the regulatory capital rule, foreign currency translation adjustments are included in regulatory capital and accumulated net gains and losses on cash flow hedges related to the hedging of items that are not fair-valued on the balance sheet are excluded from regulatory capital. These items are thus not subject to the transition provisions and, accordingly, are not listed in section 300(b)(3) of the regulatory capital rule.

**8. If the U.S. Treasury sells to a third party preferred shares issued by a depository institution holding company (DIHC) under the Emergency Economic Stabilization Act of 2008 (troubled asset relief program (TARP) shares) and the DIHC included the TARP shares in tier 1 capital, are TARP shares held by that third party eligible for inclusion in additional tier 1 capital under the regulatory capital rule?**

Yes. Although the shares do not meet the eligibility requirements under the regulatory capital rule, the shares were issued prior to October 4, 2010 pursuant to the Emergency Economic Stabilization Act and are explicitly grandfathered under the regulatory capital rule. See section 20(c)(3) of the regulatory capital rule.

**9. DIHC A has TARP shares outstanding and held by third-party investors. DIHC B acquires DIHC A. Instead of purchasing the TARP shares from the investors for cash, DIHC B exchanges the TARP shares issued by DIHC A for newly issued preferred shares that have identical terms to the TARP shares (for example, the preferred shares issued by DIHC B are cumulative and have a step-up, and are classified as a new instrument under generally accepted accounting principles (GAAP)). Are the shares issued by DIHC B eligible for inclusion in additional tier 1 capital?**

No. The shares issued by DIHC B were not issued prior to October 4, 2010, and were not issued pursuant to the Emergency Economic Stabilization Act. The terms of the newly issued shares are not consistent with the eligibility criteria under the regulatory capital rule. See section 20 of the regulatory capital rule.

**10. Are interest payments on tier 2 capital instruments included in the scope of “distributions” under the capital conservation buffer framework?**

Interest payments on subordinated debt instruments that qualify as tier 2 capital are generally not considered a “distribution” for purposes of the capital conservation buffer framework, as that

term is defined in section 2 of the regulatory capital rule. However, interest payments on trust preferred securities (TruPS) (if the TruPS are included in the tier 2 capital of the issuer) are included in the scope of distributions under the capital conservation buffer if the banking organization has full discretion to defer interest payments on those instruments (permanently or temporarily) without triggering an event of default.

### **High Volatility Commercial Real Estate (HVCRE) Exposures<sup>4</sup>**

**1. If a borrower contributes additional capital to an existing HVCRE loan to meet the 15 percent contributed capital requirement after the banking organization has already advanced funds to the borrower, can the loan be excluded from the definition of HVCRE as a loan to a commercial real estate (CRE) project that meets specified criteria?**

The loan remains an HVCRE loan because any contribution of cash or land must be contributed to the project before a banking organization advances funds for a loan to be considered a CRE loan, rather than an HVCRE loan.

**2. Are acquisition, development or construction (ADC) loans made prior to the effective date of the regulatory capital rule exempted from the HVCRE definition?**

The regulatory capital rule does not provide for the grandfathering of existing loans. Therefore, ADC loans made before the effective date of the regulatory capital rule are not automatically exempted from the definition of HVCRE. Unless such loans meet the criteria for exemption provided in the definition of HVCRE, they must be treated as HVCRE loans.

**3. If a borrower owns real estate (and has no mortgages or liens on that real estate) that is unrelated to a project, can the borrower pledge this real estate to the project as collateral and count the value of the real estate toward the 15 percent borrower contributed capital requirement and avoid the HVCRE classification?**

No, the definition of HVCRE requires that capital be contributed by the borrower to the project in the form of cash or unencumbered readily marketable assets. To the extent that an asset is merely pledged as collateral, it would not be considered to have been contributed to the project.

**4. For the purpose of determining whether a loan meets the definition of HVCRE, would various purchasers' deposits on units in a condominium project (that does not qualify as a one- to four-family property that is excluded from the definition of HVCRE) count toward the borrower's contributed capital?**

No. Purchasers' deposits on units in a condominium project do not qualify as capital contributed by the borrower. The purpose of contributed capital, or equity, is to ensure that the borrower maintains a sufficient economic interest in the property and to provide a margin between the loan amount and the value of the project to provide protection to the lender against loss due to overruns or an incomplete or otherwise failed project. Typically, a purchaser's deposit is not able to absorb losses on the project because the deposit must be returned to the purchaser in the event that the project is not completed.

---

<sup>4</sup> For HVCRE questions, see the definition of "HVCRE" in section 2 of the regulatory capital rule.

**5. For the purpose of measuring capital contributed by the borrower under the HVCRE definition, if Bank A has a first mortgage secured by the real estate of the project and Bank B has a second mortgage on the same real estate collateral, does the second banking organization’s funding count as cash contributed by the borrower?**

No. A second banking organization’s funding of the project is not considered to be capital contributed by the borrower. Rather, it is another loan to the project, and both loans encumber the property.

**6. What is the “as completed” value? Can the “as stabilized” value be used for purposes of determining whether the loan is an HVCRE exposure?**

No, the “as stabilized” value cannot be used for purposes of determining whether the loan is an HVCRE exposure. The agencies’ Interagency Appraisal and Evaluation Guidelines explain both the “as completed” value and “as stabilized” value as follows:

The prospective market value “as completed” reflects the property's market value as of the time that development is expected to be completed. The prospective market value “as stabilized” reflects the property's market value as of the time the property is projected to achieve stabilized occupancy. For an income-producing property, stabilized occupancy is the occupancy level that a property is expected to achieve after the property is exposed to the market for lease over a reasonable period of time and at comparable terms and conditions to other similar properties.

(Refer to the interagency guidelines: The Board’s SR letter 10-16 at

<http://www.federalreserve.gov/boarddocs/srletters/2010/sr1016a1.pdf>; the OCC Bulletin 2010-42 at <http://www.occ.gov/news-issuances/bulletins/2010/bulletin-2010-42.html>; and the FDIC’s FIL 82-2010 at <https://www.fdic.gov/news/news/financial/2010/fil10082a.pdf>.)

Of the three market value scenarios that are generally used by an appraiser (that is, the current [“as is”] market value, the prospective market value “as completed,” and the prospective market value “as stabilized”), a banking organization should consider only the prospective market value “as completed” for purposes of determining whether a project is an HVCRE exposure.

**7. If cash is used to buy land, and that land is subsequently contributed to a new development, can the land still count as contributed capital? Does the banking organization need to document when and how much the borrower paid for the land?**

Yes. If cash is used to purchase land that is subsequently contributed to an ADC project, the cash used to buy the land can count toward the 15 percent contributed capital amount. This 15 percent requirement must be met before the banking organization advances funds. The definition of HVCRE excludes CRE projects in which the borrower has contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid development expenses out-of-pocket) of at least 15 percent of the real estate’s “as completed” value. (See definition in question 6.) Consistent with the preamble to the regulatory capital rule, cash used to purchase land is a form of borrower-contributed capital under the HVCRE definition. The banking organization should document the details pertaining to the amount of cash paid for the land.

**8. For purposes of determining the amount of a borrower’s contributed capital and whether a loan would be classified as an HVCRE loan, would “soft costs” (such as brokerage fees, marketing expenses, or costs of feasibility studies) qualify as “development expenses”?**

Under the regulatory capital rule, contributed capital may include out-of-pocket development expenses paid by the borrower. “Soft costs” that contribute to the completion and value of the project can count as development expenses for purposes of the HVCRE definition. Such soft costs include interest and other development costs such as fees and related pre-development expenses. Project costs paid to related parties such as developer fees, leasing expenses, brokerage commissions, and management fees may be included in the soft costs provided the costs are reasonable in comparison to the cost of similar services from third parties. Acceptable contributed capital includes actual cash expended by a developer for the purchase of a site and initial costs paid, such as engineering or permits related directly to the project.

**9. Does an interest-only loan to purchase an existing building under renovation with tenants qualify as HVCRE?**

The terms of financing (for example, interest-only loans) are not a relevant criterion for HVCRE determination. Rather, the classification of the loan depends primarily on whether it is permanent financing. A loan cannot be classified as permanent financing if (1) the loan is based on the “as completed” value of the project (i.e., the project has not yet been completed) and (2) there will be any future advances on the loan. Other characteristics of the loan should also be considered in the context of the regulatory capital rule’s HVCRE definition.

**10. Are Small Business Administration (SBA) 504 loans considered community development loans under the definition of HVCRE and, therefore, not subject to the HVCRE treatment?**

SBA 504 loans are used for fixed assets (for example, the purchase of land and buildings, site and building improvements, newly constructed facilities, and long-term machinery and equipment) as well as to refinance existing debt and are not automatically excluded from the definition of HVCRE. SBA 504 loans that meet the criteria in paragraphs (2)(i) and (2)(ii) under the HVCRE definition are exempt from treatment as an HVCRE exposure. SBA 504 loans that are not community development investments may be exempt from the HVCRE treatment if the loan satisfies the other exemption criteria in the definition of HVCRE.

**11. Projects may receive cash in the form of grants from nonprofit organizations, municipalities, state agencies, or federal agencies. Can a banking organization providing ADC financing to a project (that does not otherwise qualify as a community development investment with regard to the HVCRE exemption) consider the cash from such grants as part of the 15 percent contributed capital requirement?**

No, to the extent a project receives a grant, a banking organization may not consider the cash from the grant as a capital contribution because the cash did not come from the borrower. Although a third-party grant would increase the capital invested in the project, because it does not come from the borrower, it does not affect the borrower’s level of investment and therefore does not ensure that the borrower maintains a sufficient economic interest in the project.

**12. Is a credit facility used to purchase a commercial lot (land only with no site improvements) an HVCRE exposure? The proceeds are used to acquire the land, however, there is no plan to develop, construct, or make improvements. At this time the borrower intends to hold the land.**

An acquisition loan to purchase CRE (including land) would qualify as an HVCRE exposure, unless the loan is permanent financing in accordance with the banking organization's normal lending terms or meets the exemption criteria described in the HVCRE definition.

**13. Does an ADC loan on a multipurpose property that will contain both CRE and one- to four-family residential real estate meet the HVCRE definition?**

Only the portion of the loan applicable to the property's CRE could be subject to the HVCRE treatment. The banking organization should consider the contribution of the CRE portion of the project to the total "as completed" value of the project when determining the portion of the loan applicable to the property's CRE.

**14. Subsequent to loan origination, if an updated appraisal or valuation on an HVCRE exposure results in a loan-to-value (LTV) ratio that no longer exceeds the maximum LTV ratio in the relevant supervisor's real estate lending standards, could the exposure then be removed from the HVCRE classification (if the exposure meets the other exemption criteria in paragraph (4) of the HVCRE definition)?**

No. A banking organization must consider the LTV ratio at origination when evaluating a loan against the HVCRE exemption criteria. A loan with an LTV ratio that exceeded the maximum supervisory LTV ratio at origination would remain an HVCRE exposure until it converts to permanent financing. Refer to the agencies' real estate lending standards regulations: 12 CFR part 34, subpart C (OCC); 12 CFR part 208, subpart E (Board); and 12 CFR part 365 (FDIC).

**15. The definition of HVCRE includes a provision that "the capital contributed by the borrower, or internally generated by the project, is contractually required to remain in the project throughout the life of the project." What does "contractually required" mean in this context?**

In order to meet this criterion in paragraph (4)(iii) of the HVCRE definition, the loan documentation must include terms requiring that all contributed or internally generated capital remain in the project throughout the life of the project. The borrower must not have the ability to withdraw either the capital contribution or the capital generated internally by the project prior to obtaining permanent financing, selling the project, or paying the loan in full.

**16. If a banking organization lends a borrower 15 percent against the property, independent of the project, can the proceeds from the loan count towards the obligor's 15 percent capital contribution to the project?**

No. Proceeds from a loan from the banking organization that is financing the ADC project does not count toward the 15 percent contributed capital amount.

**17. Would the issuance of a certificate of occupancy qualify the loan as having reached the stage of permanent financing? There is usually a remaining loan duration extending past the issuance of the certificate of occupancy in either the initial loan term and/or through extension options.**

A certificate of occupancy does not transform an HVCRE loan into permanent financing. The HVCRE exposure ceases to be an HVCRE exposure when it is converted to permanent financing in accordance with the banking organization's normal lending terms, or is paid in full. Generally, this would involve a new credit facility in the form of a term loan replacing the ADC facility.

## Other Real Estate and Off-Balance Sheet Exposures

### **1. What is the risk weight under the standardized approach for the on-balance sheet portion of a reverse mortgage?**

Reverse mortgages receive the same risk weight treatment as traditional residential mortgages. A 50 percent risk-weight category applies if a reverse mortgage is (1) secured by a property that is either owner-occupied or rented; (2) made in accordance with prudent underwriting standards, including standards relating to the loan amount as a percent of the market value of the property at origination of the mortgage; (3) not 90 days or more past due or in nonaccrual status; and (4) not restructured or modified. A banking organization risk weights a reverse mortgage at 100 percent if the mortgage fails to meet any of the qualifying criteria for a 50 percent risk weight (see section 32(g) of the regulatory capital rule). Any portion of a reverse mortgage exposure that is *conditionally* guaranteed by the U.S. government (for example, Federal Housing Administration (FHA) guarantees) receives a 20 percent risk weight as set forth in section 32(a)(1)(ii) of the regulatory capital rule.

### **2. For purposes of a reverse mortgage, what is the treatment for the off-balance sheet component of the mortgage?**

For available funds committed but not disbursed under the terms of the reverse mortgage contract, a banking organization should apply a credit conversion factor (CCF) of 50 percent to the undisbursed available commitment amount to calculate the exposure amount, given that such commitments are generally in effect for a period greater than one year (see section 33(b)(3) of the regulatory capital rule). The exposure amount would then receive a risk weight consistent with the risk weight treatment for residential mortgages (described above).

### **3. If a banking organization has a multipurpose facility that could include both financial and performance standby letters of credit, can the banking organization apply the lower of the two applicable CCFs (that is, 50 percent)?**

Yes. A banking organization may apply the lower of the two applicable CCFs set forth in section 33 of the regulatory capital rule for commitments to extend letters of credit in the form of a financial or a performance standby letter of credit (that is, 50 percent).

### **4. Under other multipurpose facilities, a banking organization makes a commitment that could be drawn either as a letter of credit, a revolving loan, or a term loan. What is the correct CCF?**

A banking organization may apply the lower of the two applicable CCFs set forth in section 33 of the regulatory capital rule for loan commitments (that is, 20 percent for short-term and 50 percent for long-term commitments) even though such exposures could be drawn as a letter of credit or a term or revolving loan.

### **5. In order for a residential mortgage to comply with prudent underwriting standards, can private mortgage insurance (PMI) continue to be relied upon for purposes of computing LTV ratios?**

Yes. LTV ratios can account for PMI in determining whether a loan is made in accordance with prudent underwriting standards for purposes of section 32(g)(1)(ii) of the regulatory capital rule.

## **6. May a home equity line of credit (HELOC) be considered unconditionally cancellable?**

Yes. A HELOC may be considered unconditionally cancellable to the extent it meets certain requirements. The regulatory capital rule defines unconditionally cancellable in section 2 to mean “a commitment for which a banking organization may, at any time, with or without cause, refuse to extend credit (to the extent permitted under applicable law).” In the case of a residential mortgage exposure that is a line of credit, a banking organization can unconditionally cancel the commitment if, at its option, it may prohibit additional extensions of credit, reduce the credit line, and terminate the commitment to the full extent permitted by applicable law and the regulations issued pursuant to those laws. This treatment is effectively identical to that under the general risk-based capital rules.

## **7. What is the proper capital treatment for FHA Title I loans?**

FHA Title I loans are secured by junior liens and are insured by the FHA at either a portfolio level or on an individual loan basis. The type of insurance provided by the FHA depends on the type, characteristics, and origination date of the loan.

FHA Title I loans that are insured on an individual loan basis should receive a 20 percent risk weight for the portion of the loan that is conditionally guaranteed by FHA, typically 90 percent of the outstanding loan balance, as set forth in section 32(a)(1)(ii) of the regulatory capital rule. The remaining, uninsured portion of the loan should be treated as a junior lien residential mortgage exposure for purposes of section 32(g)(2) of the regulatory capital rule.

FHA Title I loans that have portfolio insurance are considered to be securitization exposures because only a portion of the portfolio is covered by insurance and should be risk weighted according to the applicable securitization framework, as set forth in section 41(b) of the regulatory capital rule. Banking organizations also have the option to hold regulatory capital against the underlying exposures as if they are not a tranching guarantee. If this option is selected, these exposures should be treated as junior lien residential mortgage exposures.

## **8. For purposes of the regulatory capital rule’s definition of a statutory multifamily loan, can a multifamily mortgage receive a 50 percent risk weight during an interest-only period when no principal is due to be paid?**

Generally, statutory multifamily loans receive a 100 percent risk weight in the first year after origination. If the loan meets all the criteria in the statutory multifamily loan definition set forth in section 2 of the regulatory capital rule, including the timely payment of principal and interest in accordance with the terms of the loan for at least one year and the debt service coverage ratio criteria, the loan will receive a 50 percent risk weight in year two, as set forth in section 32(i) of the regulatory capital rule. For statutory multifamily mortgages with an interest-only period, there are no principal payments due during this period. Therefore, as long as the interest payments are made on a timely basis in accordance with the terms of the loan during year one, the requirement for timely payment is effectively met and the multifamily loan would be eligible to receive a 50 percent risk weight beginning in year two. In addition, the debt service coverage ratio should be calculated using the amortizing payment (principal and interest) that will occur under the terms of the loan. In the case of an adjustable loan, the amortizing payment is based on the fully indexed rate.

An interest-only loan that does not meet the other criteria in the definition of a statutory multifamily loan would generally continue to receive a 100 percent risk weight.

**9. For a residential mortgage loan that is not in default, and otherwise meets all the lending requirements for a 50 percent risk weight, what would be the appropriate risk weight for this loan after the banking organization lowers the interest rate for the sole purpose of keeping the borrower as a customer?**

Under section 32(g) of the regulatory capital rule, a residential mortgage exposure may be assigned to the 50 percent risk-weight category only if it is not restructured or modified. Lowering the interest rate without any additional underwriting or documentation would constitute a loan modification and would subject the mortgage to a 100 percent risk weight. To continue receiving the preferential 50 percent risk weight, the banking organization would need to perform additional underwriting on the loan to the extent required for the banking organization to ensure that the credit quality of the borrower has not deteriorated. Moreover, in cases where the interest rate change is to prevent any type of payment increase or other change in terms (for example, from the end of a temporary fixed rate to a scheduled floating rate, from interest-only to amortizing payments, or to address an upcoming balloon payment), then the banking organization would need to fully re-underwrite the loan to maintain the 50 percent risk weight.

### **Separate Account and Equity Exposures to Investment Funds**

**1. A banking organization has an equity exposure to an investment fund. The investment guidelines of the fund permit it to hold securitization positions up to a specified limit. Under the standardized approach, can the banking organization use the alternative modified look-through approach of section 53(d) of the regulatory capital rule to calculate the risk weight for its equity exposure to the investment fund? What risk weight should the banking organization assign to the portion of its investment in the fund that, according to the investment limits of the fund, would be securitization exposures?**

The banking organization may use the alternative modified look-through approach set forth in section 53(d) of the regulatory capital rule to assign the adjusted carrying value of its equity exposure to an investment fund on a pro rata basis to different risk-weight categories based on the investment limits for various asset types contained in the fund's prospectus, partnership agreement, or similar contract that defines the fund's permissible investments (investment guidelines). If all due diligence requirements under section 41(c) of the regulatory capital rule are met, the banking organization may assign a risk weight to the securitization portion using either the gross-up approach or the simplified supervisory formula approach (SSFA) under section 43 of the regulatory capital rule depending on which of these approaches the banking organization has chosen to use across all of its securitization exposures, among other factors specified in section 42 of the regulatory capital rule. The banking organization may use the SSFA for all of its directly owned securitization exposures and the securitization exposures held by the investment fund, if the investment guidelines limit the investment fund's holdings of securitization exposures to only exposures that would be subject to a specific risk weight under the SSFA in section 43 of the regulatory capital rule. For example, the investment guidelines could limit the fund's holdings of securitization exposures only to exposures that would be subject to a 20 percent risk weight under the SSFA. Importantly, the investment guidelines would have to specify that any securitization exposure would be divested promptly if its risk weight calculated under the SSFA goes above the specified threshold.

In order for the banking organization to apply the risk weight limit specified in the investment guidelines, it also would need to meet the due diligence requirements in section 41(c) of the regulatory capital rule, which require the banking organization to demonstrate a comprehensive understanding of the features of the securitization exposure that would materially affect its performance. The banking organization could rely on a third party (for example, the fund manager) to conduct the due diligence on the securitization exposures held by the investment fund and provide the analysis to the banking organization, provided that the banking organization has a process to assess and manage the risk of using a third party. (See, for example, the guidance issued by each agency related to outsourcing risk. Refer to [www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html](http://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html), <http://www.fdic.gov/news/news/financial/2008/fi108044.html>, and <http://www.federalreserve.gov/bankinfo/srletters/sr1319.htm>.)

**2. Could an investment in a bank-owned life insurance (BOLI) hybrid product in which the gains and losses on the pool of assets are reflected in the cash surrender value recorded on the banking organization's balance sheet meet the definition of separate account under the regulatory capital rule?**

Yes, as long as the account meets all the requirements of a separate account as defined in section 2 of the regulatory capital rule, which refers to a legally segregated pool of assets owned and held by an insurance company for the benefit of an individual contract holder. Paragraph 4 of the definition of a separate account requires, in part, that all investment gains and losses, net of contract fees and assessments, be passed through to the contract holder. Paragraph 4 would be satisfied if the gains and losses on the investment are passed through to a banking organization via changes in the on-balance sheet cash surrender value of the investment. The banking organization must not receive cash payments of any gains or earnings of the assets in the pool.

**Qualifying Central Counterparty (QCCP)<sup>5</sup>**

**1. What should a banking organization consider when determining whether a non-U.S. central counterparty (CCP) is a QCCP under paragraph (1)(ii) of the QCCP definition of the regulatory capital rule?**

A banking organization should review the CCP's home-country regulator's implementation of the "Principles for Financial Market Infrastructures" (PFMI) published by the Committee on Payment and Settlement Systems (CPSS) and the technical committee of the International Organization of Securities Commissions (IOSCO), as well as the home-country regulator's application of the PFMI to the CCP.<sup>6</sup> When conducting its review, a banking organization can take into account analyses conducted by third parties, such as industry associations, law firms or consultants, and monitoring reports on the implementation of the PFMIs published by CPSS and IOSCO.<sup>7</sup>

---

<sup>5</sup> For QCCP questions, see definition of "QCCP" in section 2 of the regulatory capital rule.

<sup>6</sup> See <http://www.bis.org/publ/cpss101a.pdf>.

<sup>7</sup> For example, see <http://www.bis.org/publ/cpss111.htm>.

**2. Can banking organizations rely on QCCP designations published by foreign supervisory or regulatory authorities? For example, the European Securities and Markets Authority plans to publish a list of CCPs outside of the European Economic Area that will be recognized as QCCPs under the European Market Infrastructure Regulation and the Capital Requirements Directive IV.**

A QCCP designation by a foreign supervisory or regulatory authority alone is not sufficient for a banking organization to determine that a CCP meets the definition of a QCCP under the regulatory capital rule. However, the designation can be presented as supporting evidence in the banking organization's demonstration that the CCP meets the definition of a QCCP under paragraph (1)(iii)(B) of the QCCP definition in section 2 of the regulatory capital rule.

**3. Does imposing an uncapped liability exposure to members automatically disqualify a CCP from qualifying as a QCCP?**

No. The definition of QCCP in section 2 of the regulatory capital rule does not automatically preclude a CCP that does not cap the liability exposures of its members from meeting the definition of a QCCP under the rule.

**4. For CCPs that clear multiple product types, is the QCCP designation made at the clearinghouse legal entity level or at the product level?**

If a CCP maintains separate default funds for each product, then a banking organization should conduct separate assessments with respect to each product segment to determine whether the CCP qualifies as a QCCP with respect to that product segment. See definition of QCCP in section 2 of the regulatory capital rule.

### **Credit Valuation Adjustment (CVA)**

**\*1. Is a clearing member banking organization's exposure to a clearing member client from a derivative transaction subject to a CVA capital charge?**

Yes. According to paragraph 2 of the definition of a cleared transaction in section 2 of the regulatory capital rule, a clearing member banking organization's exposure to its clearing member client is not a cleared transaction. Such derivative transactions are over-the-counter derivative transactions and, thus, included in the CVA capital requirement calculation. See section 132(e) of the regulatory capital rule.

Of note, the regulatory capital rule allows a clearing member banking organization to recognize a shorter margin period of risk or holding period when calculating its exposure at default (EAD) for derivative transactions with clearing member clients. This downward adjusted EAD also enters into the CVA capital requirement calculation for the clearing member banking organization's exposures to a clearing member client. See section 132(c)(8) of the regulatory capital rule.

### **Other Questions**

**1. Under the SSFA, how does a banking organization calculate  $K_G$  (that is, the weighted average capital requirement of the underlying exposures) for a securitization exposure**

**backed by Sallie Mae student loans that are guaranteed by the U.S. government? What risk weight does the banking organization use for the portion of the underlying exposure that is guaranteed?**

The portion of a Sallie Mae loan conditionally guaranteed by the U.S. government is subject to a risk weight of 20 percent, pursuant to sections 43(b) and 32(a)(1)(ii) of the regulatory capital rule. If 97 percent of an underlying exposure is conditionally guaranteed by the U.S. government, 97 percent of that exposure would be risk weighted at 20 percent. The portion of the remaining 3 percent that is performing would be risk weighted at 100 percent and any portion of the remaining 3 percent that is 90 days or more past due or on non-accrual would be risk weighted at 150 percent. See sections 43(b) and 32(k) of the regulatory capital rule.

**2. Is a loan that has a “due on demand” clause considered unconditionally cancellable?**

The incorporation of a demand clause, by itself, does not meet the definition of unconditionally cancellable under section 2 of the regulatory capital rule because it may not extinguish the borrower’s ability to make future draws on the credit facility. Under section 2 of the regulatory capital rule, the term “unconditionally cancellable” means that the banking organization “may, at any time, with or without cause, refuse to extend credit under the commitment (to the extent permitted under applicable law).”

**\*3. What disclosure requirements are advanced approaches banking organizations subject to once they exit parallel run?**

Top-tier advanced approaches banking organizations that exit parallel run are subject to the disclosure requirements described in sections 172 and 173 of the regulatory capital rule. If an advanced approaches banking organization has not exited parallel run, it is subject to the public disclosure requirements described in sections 61 to 63 of the standardized approach beginning in 2015 if it has \$50 billion or more in total consolidated assets.