

## THE NEW CAPITAL FRAMEWORK PROPOSALS: ENHANCED BURDENS ACROSS THE BANKING INDUSTRY

June 13, 2012

To Our Clients and Friends:

On June 7, 2012, the Board of Governors of the Federal Reserve System (the “Board”) voted in favor of a comprehensive set of three capital proposals (collectively, the “Proposals”) ultimately designed to apply, in whole or in part, to all insured banks and thrifts, savings and loan holding companies (“SLHCs”), and bank holding companies (“BHCs”) with consolidated assets over \$500 million.<sup>1</sup> On June 12, 2012, the Board, the Federal Deposit Insurance Corporation (the “FDIC”) and the Office of the Comptroller of the Currency (the “OCC”) (collectively, the “Agencies”) jointly published the Proposals,<sup>2</sup> and they soon will be published in the *Federal Register* with a comment period extending (only) until September 7, 2012. Given the fundamental importance of capital to all activities and investments of a banking organization, the banking industry and their trade groups can reasonably expect to be heavily engaged throughout this process.

In large part, the Proposals implement and seek to harmonize the regulatory capital standards promulgated by the Basel Committee on Banking Supervision (the “BCBS”), an international committee consisting of representatives of central banks and other agencies, in “Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems” (“Basel III”),<sup>3</sup> and the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”). The Agencies conducted an impact analysis in the course of developing these capital proposals which they believe indicates that “the vast majority of banking organizations currently would meet the fully phased-in

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<sup>1</sup> The Proposals are available at <http://www.federalreserve.gov/newsevents/press/bcreg/20120607a.htm>.

<sup>2</sup> See <http://www.federalreserve.gov/newsevents/press/bcreg/20120612a.htm>.

<sup>3</sup> See *Bank for International Settlements, Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (2011), available at <http://www.bis.org/publ/bcb3189.pdf>. See also Debevoise & Plimpton LLP *Financial Institutions Report* (Jan. 2011), *Basel III: An Initial Piece of the Global Puzzle*, available at <http://www.debevoise.com/files/Publication/d81ab1da-d5ad-4bc3-8c27-f19cb8eabb5d/Presentation/PublicationAttachment/a38b6dea-e50c-4824-b848-1a5f34a7fd05/FIRreport/January2011.pdf>.

minimum capital requirements as of March 31, 2012.”<sup>4</sup> Nonetheless, unfortunately for the banking industry, rather than reducing some of the Basel III capital burdens in light of the additional activity and other limits imposed by Dodd-Frank, the Proposals generally seem to employ a “highest common denominator” approach to the capital requirements. The cumulative (rather than offsetting) burdens of the international capital rules and Dodd-Frank have already imposed significant costs on the banking industry and are contributing to a possible downgrade by Moody’s Investors Service of five of the largest six U.S. financial firms by the end of this month.<sup>5</sup> Particularly given the difficulties inherent in banks issuing Tier 1 capital (increasingly focused on common equity, as discussed below), if the Proposals are not eased, large U.S. banks likely will be forced to largely continue to focus on asset sales and retention of earnings, rather than expansion, and smaller banking institutions (to many of whom the applicability of the Proposals is unto itself a significant surprise) will increasingly find it difficult to remain viable.

The Proposals Consist of Three Components:

- (1) “Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action” (the “Capital NPR”) focuses on establishing new risk-based and leverage capital ratios, as well as what constitutes “capital” (*i.e.*, the numerator of the capital ratios), and will be phased in from 2013 through 2019;
- (2) “Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements” (the “RWA NPR”) focuses primarily on the risk-weighting of the assets and activities in which banking organizations engage (*i.e.*, the denominator of the capital ratios, effective on January 1, 2015); and
- (3) “Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule” (the “Advanced Approaches NPR”) includes revisions to the advanced approaches risk-based capital rules (Basel II) that apply only to the largest or most internationally active U.S. banking organizations (referred to herein as “advanced approaches institutions”), to bring them in line with Basel III and Dodd-Frank.

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<sup>4</sup> See Board, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action* 17 (June 7, 2012).

<sup>5</sup> Kelly Nolan et al., *Big U.S. Banks Brace for Downgrades*, *Wall St. J.*, June 9, 2012, at A1.

As its name suggests, the Advanced Approaches NPR (component (3)) is an enhancement of the Basel II rules, and thus applies only to the largest or most internationally active U.S. institutions. The Capital NPR (component (1)) and RWA NPR (component (2)) apply to all other U.S. depository institutions, as well as BHCs with consolidated assets above \$500 million and all SLHCs (including those that are part of an insurance group). The Collins Amendment, section 171 of Dodd-Frank, also makes the Capital NPR and RWA NPR fully applicable to the largest U.S. banking organizations, however, because the Collins Amendment requires the largest institutions to use the higher of the “generally applicable” capital charge and the charge applicable under the advanced approaches.<sup>6</sup> In sum, components (1) and (2) are relevant for all but the advanced approaches institutions, and all three components are relevant to advanced approaches institutions.

According to the Financial Services Roundtable, whom Debevoise will represent in this effort, the Proposals, combined with an additional final rule relating to market risk,<sup>7</sup> in aggregate weigh over 8.5 pounds, and in no way decrease the complexity for which bank capital rules already are well recognized. This update seeks to provide both a thorough discussion of the Proposals and some of their practical implications and variations from the historical rules (through text), and summaries for quick reference in the following appendices:

**Appendix A – Proposed Regulatory Capital Levels; Implementation Schedule**

**Appendix B – Implementation of the Capital Conservation and Countercyclical Capital Buffer**

**Appendix C – A Comparison of Current and Proposed Prompt Corrective Action Levels**

**Appendix D – A Comparison of Current and Proposed Risk Weights**

**Appendix E – Capital Treatment of Insurance-Specific Assets and Activities**

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<sup>6</sup> Consistent with section 171(b)(4)(E) of the Dodd-Frank Act, the Proposals would not apply to U.S. subsidiaries of foreign banking organizations that rely on the Board’s SR 01-1 until July 21, 2015.

<sup>7</sup> Available at <http://www.federalreserve.gov/newsevents/press/bcreg/20120607b.htm>.

A future update will discuss the other major capital proposal issued by the Board last week, a final rule relating to the market risk capital rule that is applicable to institutions with significant trading books.<sup>8</sup> Yet to be addressed by the Agencies (until greater international progress is made): the liquidity rules, and the additional capital surcharges applicable to the largest international institutions.

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<sup>8</sup> *Id.*

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## THE CAPITAL NPR

### BACKGROUND: IMPLEMENTATION OF THE BASEL III FRAMEWORK

A common theme underlying capital reform initiatives of the past several years is that the financial crisis became so severe, in large part, because banking institutions in many countries had incurred excessive on- and off-balance sheet leverage, while holding insufficient high-quality capital and inadequate liquidity buffers. As a result, banks could not withstand their systemic trading or credit losses or address the migration of off-balance sheet exposures onto their balance sheets. These problems were exacerbated by the pro-cyclical deleveraging process after the crisis began, and by the interdependency and interconnectedness of financial institutions.

The Basel III accord (finalized in 2010) attempts to address these perceived concerns and strengthen the regulatory capital framework by (i) increasing the required quality and quantity of the capital base (the numerator of the capital ratios), including via capital conservation and countercyclical buffers; (ii) reducing the range of instruments that count as capital; (iii) increasing the risk-weighted asset assessment for certain types of activities (the denominator of the capital ratios); and (iv) introducing a leverage ratio as an addition to the risk-capital ratios that historically have been the exclusive capital measure in Basel II. The Capital NPR implements the first two of these Basel III initiatives. Moreover, while (unlike their E.U. counterparts) U.S. banks have been subject to a leverage ratio (the fourth element) for many years, the Capital NPR (unlike Basel III) expands it for advanced approaches institutions to include certain off-balance sheet items. The third element, risk-weighted assets, is addressed in section II below.

### THE QUANTITY OF CAPITAL: CAPITAL RATIOS

#### 1. The Base Capital Ratios

Consistent with Basel III, the Capital NPR establishes:

- a new common equity Tier 1 (“Common Equity Tier 1”) capital ratio of 4.5%;
- a Tier 1 capital ratio, with a numerator consisting of the sum of Common Equity Tier 1 and additional Tier 1 (“Additional Tier 1”) capital, of 6% (increased from 4%); and

- a total capital (“Total Capital”) ratio, with a numerator consisting of the sum of Common Equity Tier 1, Additional Tier 1 and Tier 2 capital, of 8% (unchanged from current rules).

The new capital ratios would apply to affected banking organizations (*e.g.*, all U.S. depository institutions and SLHCs, and BHCs with over \$500 million of assets) on a consolidated basis. The required minimum Common Equity Tier 1 ratio of 4.5% is designed to ensure that banks maintain more core capital, consisting predominantly of common shares and retained earnings, than historically has been required. The concept of a Common Equity Tier 1 ratio was introduced in Basel III, and it arose from a general concern that the “hybrid” instruments allowed in Tier 1 historically did not provide significant support to banks during the financial crisis,<sup>9</sup> and many banking organizations, particularly in Europe, had relatively little common equity capital. The Common Equity Tier 1 ratio is thus designed to ensure that banking organizations have a minimum amount of the highest grade, highest support-providing capital, which generally will be common stock.

While the enhanced capital ratios will be burdensome on all affected institutions, the Capital NPR is arguably harshest on those institutions (*e.g.*, SLHCs) that were permitted to have a longer grace period (5 years) for such requirements by the Collins Amendment. The expanded application of the Capital NPR will both impose new capital requirements more quickly on these institutions, and force them to move more expeditiously to develop the necessary reporting systems than the Collins Amendment led them to believe would occur.

The base capital ratios set forth in this section B.1, however, in no way portray the full capital burden. Rather, sections B.2-B4 and accompanying appendices, are necessary to understand the full burdens that will be imposed on large and small banking institutions.

Please refer to Appendix A for a table showing the regulatory capital levels banking organizations would generally need to meet during the transition period, including the timeline for implementation of the capital conservation buffer (discussed below).

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<sup>9</sup> For example, the FDIC in 2010 published a report asserting that trust preferred securities provided inadequate capital support during the financial crisis. See FDIC, *Trust Preferred Securities and the Capital Strength of Banking Organizations: FDIC Supervisory Insights--Winter 2010*, available at <http://www.fdic.gov/regulations/examinations/supervisory/insights/siv10/trust.html>.

## 2. Capital Conservation and Cyclical Buffers

- Capital Conservation Buffer – Applicable to all Banking Organizations

International regulators perceive that during the financial crisis, because reductions in distributions could indicate a signal of weakness, banking organizations continued to pay dividends and make other discretionary expenditures of their capital, including bonuses and share buybacks, even after their capital position deteriorated. To address this concern, the Capital NPR, consistent with Basel III, establishes a “capital conservation buffer” of 2.5% above the regulatory minimum capital requirements, which must consist entirely of Common Equity Tier 1 capital. As a result, if a banking organization does not have common equity, Tier 1 and total capital ratios of at least 7%, 8.5% and 10.5%, respectively, its ability to pay dividends and discretionary bonuses or engage in share repurchases will be restricted. When a banking organization’s capital levels fall within the buffer at the end of a quarter, a maximum payout ratio will be imposed on the bank, and in the following quarter the organization will be required to conserve a percentage of its earnings, with only that portion equal to the maximum percentage ratio available for distribution.

The closer a banking organization’s capital falls toward the minimum capital levels, the more constrained its ability to make discretionary payments will be. Although the capital conservation buffer is not incorporated in the PCA rules, and thus whether or not a banking organization maintains the buffer will not affect its capital category (meaning that it could still be well-capitalized without maintaining the capital conservation buffer), it is likely that the new buffer will be viewed as establishing an even higher de facto minimum capital requirement because it will provide very significant incentive to conserve capital in excess of the regulatory minimum.

- Implementation of the Capital Conservation Buffer

The capital conservation buffer will be phased in beginning January 1, 2016, beginning at 0.625% of risk-weighted assets and increasing by that amount each year until it becomes fully effective on January 1, 2019. The discretion to institute a countercyclical buffer (described immediately below) will be phased in at the same rate in tandem with the capital conservation buffer over the same period.

*Please refer to Appendix B for a table showing the timeline for implementation of the capital conservation buffer and the maximum payout ratios associated with maintaining less than the full buffer.*

- Countercyclical Buffer – Applicable to Advanced Approaches Institutions Only

The Capital NPR again tracks Basel III by providing the Agencies discretion to institute a “countercyclical buffer” applicable only to advanced approaches institutions if the Agencies perceive a greater system-wide risk to the banking system as the result of a build-up of excess credit growth. In the U.S., it will initially be set at zero, and is anticipated to be implemented on only an infrequent basis, with twelve months’ notice unless the Agencies determine that economic conditions warrant a more aggressive timetable. If implemented, the countercyclical buffer would (in tandem with the capital conservation buffer) restrict discretionary distributions by advanced approaches organizations, and incentivize retention of up to an additional 2.5% of Common Equity Tier 1 capital, resulting in minimum common equity, Tier 1 and total capital ratios of up to 9.5%, 11% and 13%, respectively. Internationally active banking organizations would be subject to an organization-specific countercyclical buffer that represents the weighted average of the countercyclical buffers that are being applied in jurisdictions to which they have exposure.

### 3. Leverage Ratio

One of Basel III’s sharpest departures from the prior international capital accords was the introduction of a global leverage ratio as a “backstop” to the risk-based capital requirements, to prevent the building of excessive on-and-off balance sheet leverage and the associated economic damage resulting from deleveraging during difficult economic periods. U.S. banking organizations, however, have been required to comply with a minimum leverage measure of capital since the early 1980s.

- Generally Applicable Leverage Ratio

In the Capital NPR, the Agencies propose to apply the current 4% leverage ratio requirement of Tier 1 Capital (as modified by the revised definition of Tier 1 Capital) to total on-balance sheet assets (net of amounts deducted from Tier 1 Capital) of 4% across the board to all banking organizations (including highly rated banking organizations, which heretofore had benefited from an exception providing for a more permissive leverage ratio of 3%), while reserving the more stringent Basel III formulation of the leverage ratio to apply only to advanced approaches institutions, as a new supplementary leverage ratio. As shown in Appendix C, the revisions to the PCA framework maintain a minimum leverage ratio of 5% in order for an institution to be well capitalized.

- Supplementary Leverage Ratio – Applicable to Advanced Approaches Institutions Only

The numerator of both ratios would be based on Tier 1 Capital, but the denominator of the supplementary leverage ratio (which, again would apply only to advanced approaches institutions) would include certain off-balance sheet exposures. The measure of exposure for the supplementary leverage ratio would be the sum of (i) on-balance sheet assets net of deductions from Tier 1 Capital, (ii) potential future exposure to derivatives, (iii) 10% of the notional amount of unconditionally cancellable commitments, and (iv) the notional amount of all other off-balance-sheet exposures (excluding securities lending, securities borrowing and reverse repos). Significantly, under this formula, securities lending and other repo-style transactions would flow through to the denominator only when they constitute on-balance sheet assets (as in the generally applicable leverage ratio). The Capital NPR notes that the Agencies, together with the BCBS, are engaging in an ongoing quantitative analysis of the exposure measure for such transactions, and depending on international determinations may modify the method of calculating leverage exposure (presumably to include off-balance sheet elements) in the future.

- Implementation

The supplementary leverage ratio would be calculated by advanced approaches institutions on a monthly basis beginning January 1, 2015, and reported quarterly as an arithmetic mean of the monthly results. However, it would not apply as a regulatory requirement until 2018.

#### 4. Revisions to the Prompt Corrective Action (“PCA”) Framework

The Capital NPR would amend the current PCA framework to include the new Common Equity Tier 1 capital measure and revised minimums effective January 1, 2015. An advanced approaches institution would have to meet or exceed the new supplementary leverage measure (discussed below) as of January 1, 2018 to be considered “adequately capitalized.”

*Please refer to Appendix C for a table comparing the current and proposed risk-based and leverage capital thresholds for each of the PCA capital categories for insured depository institutions.*

#### THE QUALITY OF CAPITAL: CAPITAL COMPONENTS

Having set forth the applicable ratios in section I.B above, this section I.C discusses how the Capital NPR defines the applicable components of capital (and deductions therefrom) in greater detail.

## 1. Composition of Capital

Common. To be included in Common Equity Tier 1 capital, the Capital NPR directs that a banking organization's capital instruments must, among other things: (i) be paid in, be issued directly by the banking organization, and represent the most subordinated claim in the organization's liquidation; (ii) have no maturity date and be redeemable only with regulatory approval through discretionary repurchases; (iii) not create any expectation that the instrument will be bought back, redeemed or cancelled; and (iv) not be secured or guaranteed by the banking organization or any related entity.

Unrealized gains/losses. Significantly, unrealized losses and gains on all available-for-sale ("AFS") securities would flow through to Common Equity Tier 1 capital. The potential resulting volatility due to fluctuations in benchmark interest rates could change a banking organization's risk-based capital ratios and PCA category. The magnitude of this potential downside could discourage banking organizations from holding highly liquid instruments with very low credit risk that would otherwise be prudent investments from a liquidity management standpoint.

Additional Tier 1. In addition to adopting Basel III's common equity-focused metric, the Capital NPR, again consistent with Basel III, more generally reflects the view that the historical definition of Tier 1 was too permissive with respect to hybrid capital instruments. As a result, to be included in Additional Tier 1 capital (which along with Common Equity Tier 1 Capital constitutes the numerator of the Tier 1 Capital Ratio), an instrument must, among other things: (i) be subordinated to depositors, general creditors and the bank's subordinated debt holders in a receivership, bankruptcy, liquidation or similar proceeding, (ii) not be secured or guaranteed by the banking organization or any affiliate, (iii) be perpetual, without any maturity date or any incentive to redeem (such as step-ups), (iv) be callable only with regulatory approval after at least 5 years unless the instrument ceases to be included in Additional Tier 1 capital as the result of a regulatory event, (v) provide the banking organization with the unrestricted ability to cancel distributions at any time, (vi) if classified as liabilities, have principal loss absorption through conversion to common shares or write-down at a pre-specified trigger point, and (vii) for an advanced approaches banking organization, disclose that the instrument holders may be fully subordinated to U.S. government interests. The Capital NPR notes that the Agencies are considering an additional eligibility requirement for Additional Tier 1 capital, that banking organizations have the ability to cancel or substantially reduce dividends on such instruments despite paying a "penny dividend" on common shares (because some institutional investors can not hold non-dividend paying shares).

Hybrids Eliminated. As a result of the foregoing, current Tier 1 capital instruments with step-ups, dividend pushers or similar “innovative” or “exotic” traits will be phased out pursuant to the timing discussed in subsection (3) below. This phase-out, for example, will disqualify U.S. trust preferred securities (“TRuPS”) and certain other types of hybrid capital from Tier 1 capital. Indeed, many BHCs are anticipated to use the Capital NPR as a basis to trigger a redemption of their TRuPS. Stated differently, non-cumulative perpetual preferred stock is the only type of existing widely distributed security clearly able to qualify under this category, and in fact analysts have estimated that “banks could issue an additional \$80 billion of preferreds over the next few years.”<sup>10</sup>

Minority. Minority interests, currently generally included in Tier 1, would be included to a limited extent, based on the amount of capital held by the subsidiary relative to the capital ratios with which the subsidiary would have to comply (including the buffers) if it were a banking organization. Furthermore, minority interests would be includable in Common Equity Tier 1 only if (i) the instrument giving rise to the minority interest would meet all of the criteria for Common Equity Tier 1 if issued by the banking organization, and (ii) the subsidiary that issues the instrument is itself a depository institution or foreign bank. In the case of additional Tier 1 minority interests, the subsidiary issuing the capital need not be a bank, but any instrument giving rise to the minority interest must meet all the criteria for a Common Equity Tier 1 instrument or Additional Tier 1 instrument. Similarly, for total capital minority interests, the subsidiary issuing the capital need not be a bank, but the instrument giving rise to the minority interest must meet the criteria for a Common Equity Tier 1 instrument or Additional Tier 1 or Tier 2 capital instrument.

REIT. Consolidated REIT subsidiaries’ preferred shares may be included as Tier 1 or Tier 2 minority interests, provided the shares meet all of the eligibility criteria applicable to Additional Tier 1 or Tier 2 capital, respectively. Significantly, to qualify as a Tier 1 minority interest, REIT issuers must have the ability to cancel dividends or declare a consent dividend with respect to their preferred shares.

Tier 2. Tier 2 capital is also tightened by establishing a single set of criteria to qualify, including that the instrument (i) be subordinated to depositors and general creditors of the banking organization, (ii) not be secured or covered by a guaranty of the banking organization or an affiliate, (iii) have an original maturity of at least 5 years, with no incentive

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<sup>10</sup> Danielle Robinson, *New Fed Rules Seen Triggering \$30bn of TRuPS Redemptions*, Reuters, (June 8, 2012), available at <http://www.reuters.com/article/2012/06/08/markets-credit-idUSL1E8H8E4120120608>.

to redeem (including step-ups), (iii) provide the holder no contractual right to accelerate the payment of principal or interest, except in receivership, bankruptcy, liquidation or similar proceeding, (iv) not have a credit-sensitive feature, (v) be redeemed prior to maturity or repurchase only with regulatory approval, and (vi) if issued after January 1, 2013, disclose that holders may be fully subordinated to U.S. government interests in the event of bankruptcy or similar proceeding. Because unrealized gains and losses on AFS equity securities would flow through to Common Equity Tier 1, the proposal would no longer permit a portion of unrealized gains to be included in Tier 2 capital.

Finally, there are no longer limits on the amount of Tier 2 capital that could be included in a bank's total capital or on Tier 2 term subordinated debt, limited-life preferred stock or trust preferred securities.

## 2. Deductions from and Adjustments to Capital

Emphasizing the importance of maintaining a strong common equity base, regulatory adjustments to capital would be made for the most part at Common Equity Tier 1, rather than the more general Additional Tier 1 capital, level. More specifically, goodwill and other intangibles (except mortgage servicing rights), as well as deferred tax assets that would be realized only upon future profitability, would be deducted from Common Equity Tier 1. Allocating deductions at the Common Equity Tier 1 level results in them rippling through the entire capital framework. Also of note is that the proposal would require savings associations to deconsolidate and deduct their investments in subsidiaries that engage in activities that are impermissible for national banks from their assets and regulatory capital. Similarly, as is currently the case, investments by a national bank in financial subsidiaries would be deducted from the bank's Common Equity Tier 1 capital.

Mortgage servicing rights, significant investments in the common shares of banks, insurance and other financial entities that are outside the scope of regulatory consolidation, and deferred tax assets arising from temporary differences may all to a limited degree be recognized as Common Equity Tier 1 capital, with recognition of each capped at 10% of the bank's Common Equity Tier 1 capital level. Moreover, banking organizations must deduct from Common Equity Tier 1 the amount by which the aggregate of these items exceeds 15% of Common Equity Tier 1. The amount not deducted would be risk-weighted at 250%, further discouraging banking organizations from holding such assets. These limits on mortgage servicing rights had been opposed with particular vehemence by the banking industry and its trade groups, although some institutions have sold or are contemplating selling servicing units in expectation of this undesirable result in the Capital NPR.

The Capital NPR further notes that, once regulations implementing section 619 of Dodd-Frank (commonly known as the “Volcker Rule”) have been finalized, requiring covered banking organizations to deduct from Tier 1 capital the value of their investments in hedge and private equity funds, the Agencies will revise the regulatory capital rules to reflect (and not double-count) those deductions.

### 3. Implementation and Phase-in

The phase-in of deductions from capital that qualifies as common equity (*e.g.*, for investments in financial institutions, mortgage servicing rights and deferred tax assets) will proceed by 20% annual increments beginning in January 2014, with the exception of goodwill, which must be fully deducted from Common Equity Tier 1 beginning in 2013. Moreover, while the definition of common equity will be set as of January 2013, existing instruments that no longer qualify as non-common equity-based Tier 1 or Tier 2 capital will be phased out ratably over either a three-year (for BHCs and SLHCs with  $\geq$  \$15 billion in assets) or a ten-year (for smaller institutions) horizon beginning in 2013.

#### SYSTEMICALLY IMPORTANT INSTITUTIONS - MORE TO COME

The Capital NPR notes that U.S. regulators still are developing rules to address risks posed to the financial system and the economy as a whole by systemically important financial institutions (“SIFIs”). It also notes that the BCBS is continuing its work to determine (i) qualitative and quantitative factors to assess the systemic importance of financial institutions at a global level, and (ii) how best to mitigate systemic risk. Measures the Basel Committee is considering with respect to SIFIs include additional capital surcharges, contingent capital and bail-in debt. Meanwhile, sections 165 and 166 of the Dodd-Frank Act task the Board with imposing heightened prudential standards on systemically important financial institutions (BHCs with  $\geq$  \$50 billion assets and nonbank SIFIs), including enhanced risk-based and leverage requirements. The Board initiated this process with a proposed rule on January 5, 2012 regarding the enhanced prudential standards and early remediation requirements.<sup>11</sup> The Capital NPR notes that the Board intends to supplement its January 5 proposal by implementing a quantitative risk-based capital surcharge for such institutions (or a subset of them), and that the OCC may do likewise with respect to globally significant

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<sup>11</sup> *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies*, 77 Fed. Reg. 594 (Jan. 5, 2012).

national banks, likely to be based on the BCBS methodology. Rules are expected to be implemented in 2014 and phased in from 2016 through 2019.

## The RWA NPR

The RWA NPR proposes modifications to the calculation of risk-weighted assets that also would apply to all banking institutions covered by the capital ratios described above. The RWA NPR addresses: (i) a proposed alternative standard of creditworthiness consistent with Section 939A of Dodd-Frank; (ii) revisions to recognition of credit risk mitigation; (iii) rules for risk weighting of equity exposures and past due loans; (iv) revised capital treatment for derivatives and repo-style transactions; and (v) disclosure requirements for top-tier banking organizations with \$50 billion or more in total assets that are not subject to the advanced approaches rule. Banking organizations would be required to calculate risk-weighted assets using the methodologies described in the RWA NPR beginning January 1, 2015.

### CALCULATION OF RISK-WEIGHTED ASSETS

Banking organizations would calculate total risk-weighted assets as they would under the current risk-based capital rules, by adding together on- and off-balance sheet risk-weighted asset amounts and making necessary capital deductions or other adjustments. More specifically, on-balance sheet items would be assigned risk weights based on the category of exposure, counterparty and collateral or guarantor, if applicable. Risk weights for off-balance sheet items would be calculated by multiplying the off-balance sheet exposure amount by a credit conversion factor and then assigning the credit equivalent amount to a risk-weight category.

### RISK-WEIGHTED ASSETS FOR GENERAL CREDIT RISK

The RWA NPR would include as general credit risk exposures the following categories of a banking organization's exposure: (i) on-balance sheet exposures; (ii) OTC derivative contracts; (iii) off-balance sheet commitments; (iv) trade and transaction-related contingencies; (v) guarantees; (vi) repo-style transactions; (vii) financial standby letters of credit; (viii) forward agreements; and (ix) other similar transactions. The following section summarizes the RWA NPR's proposal for treatment of various exposures. For ease of reference, italics are used to distinguish between the current risk-based capital rules and corresponding provisions in the RWA NPR.

## 1. Exposures to Sovereigns

The RWA NPR retains the current risk-weighting rules for exposures to debt directly and unconditionally guaranteed by the U.S. government and its agencies. Such exposures, including portions of deposits insured by the FDIC, would receive a zero percent risk-weight.<sup>12</sup> Risk weights for exposures to sovereigns other than the U.S. government would be based on whether the sovereign is a member of the Organization for Economic Co-Operation and Development (“OECD”) and whether the exposure is unconditionally or conditionally guaranteed. Specific risk weights for such obligations would be determined using the OECD’s Country Risk Classification (“CRC”) system. The CRC methodology, established in 1999, assigns one of eight risk categories (0-7) to each country, with countries assigned to the zero category having the lowest possible risk assessment and countries assigned to the 7 category having the highest possible risk assessment.<sup>13</sup>

The RWA NPR provides a proposed conversion chart to determine how the CRC would translate into risk weights. In recognition of current events not yet reflected in the CRC, however, the RWA NPR would require a 150 percent risk weight to sovereign exposures immediately upon an event of sovereign default or if such event has occurred in the last five years.

## 2. Exposures to Certain Supranational Entities and Multilateral Development Banks

The current risk-based capital rules apply a 20 percent risk weight to supranational entities and multilateral development banks. The RWA NPR proposes, consistent with Basel III, to apply a zero percent risk-weight to exposures of the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund and certain multilateral development banks.

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<sup>12</sup> Exposures conditionally guaranteed by the U.S. government, its central bank, or a U.S. government agency would receive a 20 percent risk weight.

<sup>13</sup> The distribution of CRCs for European countries and territories is as follows: 49% Classification 0; 12% No Classification; 8% Classification 4; 8% Classification 5; 8% Classification 6; 8% Classification 7; 0% Classification 1; 0% Classification 2.

### 3. Exposures to Government-sponsored Entities

The OCC's general risk-based capital rules for national banks currently allow a banking organization to apply a 20 percent risk weight to preferred stock of government-sponsored entities. The RWA NPR proposes assignment of 20 percent risk weight to non-equity exposures to government-sponsored entities and 100 percent risk weight to preferred stock issued by a government-sponsored entity.<sup>14</sup> This is consistent with the current FDIC and Board risk-based capital rules, and reflects the Agencies' view that because these organizations are not backed explicitly by the full faith and credit of the United States (despite being under conservatorship of the U.S. government), exposures to them their capital instruments should not be accorded the same treatment as instruments that do.

### 4. Exposures to Depository Institutions, Foreign Banks, and Credit Unions

*The current risk-based capital rules provide for a 20 percent risk weight to exposures to U.S. depository institutions and foreign banks incorporated in an OECD country, while exposures to foreign banks in non-OECD countries receive a 20 percent risk weight for short-term obligations and a 100 percent risk weight for long-term obligations.* The RWA NPR proposes to use the Basel III framework's allowance for exposures to a bank to be one risk-weight category higher than that of the bank's home country.

In this regard, exposures to U.S. depository institutions would be assigned a risk-weight of 20 percent. Exposures to foreign banks would be assigned a risk weight in line with a CRC one category higher (and thus to the disadvantage of holders) than that assigned to the bank's home country. Exposures to foreign banks in a country that does not have a CRC would receive a 100 percent risk weight. If either a sovereign default occurs in a banking organization's home country or has occurred in the past five years, the exposure would receive a 150 percent risk weight.

### 5. Exposures to Public Sector Entities

The current risk-based capital rules assign a 20 percent risk weight to general obligations of states and other political subdivisions of OECD countries and to U.S. states and municipalities. Exposures that rely on repayment from specific projects are assigned a risk weight of 50 percent. The RWA NPR proposes to include such entities in the definition of

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<sup>14</sup> *The current risk-based capital rules call for a 20 percent risk weight for preferred stock issued by government-sponsored entities.*

“public sector entity” (“PSE”), which would also include any political subdivision of a sovereign. The definition would expressly exclude government-owned commercial companies that engage in activities conducted in the private sector.

Banking organizations would assign a 20 percent risk weight to general obligations of a PSE that is organized under the laws of the United States and a 50 percent risk weight for a revenue obligation of such an entity. Exposure to PSEs in foreign countries would be based on the CRC assigned to the PSE’s home country and whether the obligation is either a general obligation or revenue obligation.

#### 6. Corporate Exposures

The current risk-based capital rules require assignment of a 100 percent risk weight category to credit exposure to companies that are not depository institutions or securitization vehicles. The RWA NPR proposes that corporate exposures be handled in a manner consistent with the current risk-based capital rules, *i.e.* banking organizations would be required to assign a 100 percent risk weight to all corporate exposures. Corporate exposure would be defined as exposures to a company that is not otherwise provided for in the rules.<sup>15</sup> Perhaps the most significant change is that while the Basel III capital framework treats certain exposures to securities firms like exposures to depository institutions, the RWA NPR would require banking organizations to treat such exposures to securities firms as corporate exposures (and thus be subject to a 100%, rather than a 20%, risk weight).

#### 7. Residential Mortgage Exposures

In certain respects, the Standardized Approach proposes a risk-weight framework that diverges from both the current risk-based capital rules (which generally impose a 50% capital charge on these assets) and the Basel II capital framework. The RWA NPR would replace the current approach with an approach based on the mortgage’s loan-to-value (“LTV”) ratio and whether the residential mortgage exposure fell within category 1 or category 2.

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<sup>15</sup> *A sovereign, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, an MDB, depository institution, a foreign bank, or a credit union, a PSE, a GSE, a residential mortgage exposure, a pre-sold construction loan, a statutory multifamily mortgage, an HVCRE exposure or a cleared transaction, a default fund contribution, a securitization exposure, an equity exposure or an unsettled transaction.*

Category 1 residential mortgage exposures would need to meet eight specific enumerated conditions, while category 2 residential mortgage exposures would function as a “catch all” for all exposures not deemed category 1 exposures. Banking organizations would be required to calculate a residential mortgage’s LTV ratio according to an enumerated methodology, based on the unpaid principal balance of the loan and the value as determined through an appraisal and evaluation conducted in conformance with the Agencies’ existing guidance.<sup>16</sup> Importantly, the RWA NPR would retain the current risk-based capital treatment for residential mortgages guaranteed by the U.S. government or its agencies, with residential mortgage exposures unconditionally guaranteed by the U.S. government or its agencies receiving a zero percent risk weight, and residential mortgages conditionally guaranteed by the U.S. government or its agencies receiving a 20 percent risk weight.

#### 8. Pre-sold Construction Loans and Statutory Multifamily Mortgages

The RWA NPR maintains the current risk-based capital rule that assigns either a 50 percent or 100 percent risk weight to certain one-to-four family residential pre-sold construction loans and to multifamily residential loans. Pre-sold construction loan would be subject to a 50 percent risk weight unless the purchase contract has been cancelled. The RWA NPR provides that a “pre-sold construction loan” is any one-to-four family residential construction loan to a builder that meets the requirements of the RTCRRI Act and other specified criteria.

#### 9. High Volatility Commercial Real Estate Exposures

The RWA NPR provides new risk-based capital rules for certain commercial risk-based capital rules. A high volatility commercial real estate exposure (“HVCRE”) is defined as “a credit facility that finances or has financed the acquisition, development or construction of real property, unless the facility finances either one-to-four family residential property or commercial real estate projects which meet certain criteria including the amount of borrower contributed capital used to finance the project,” would be assigned a 150 percent risk weight. Any commercial real estate loan that does not meet the HVCRE definition would be treated as a normal corporate exposure (subject to the 100% risk weight as set forth above).

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<sup>16</sup> See 12 CFR part 34, subpart D and 12 CFR part 160 (OCC); 12 CFR part 208, subpart E (Board); 12 CFR part 323 and 12 CFR 390.442.

## CLEARED TRANSACTIONS

Cleared transactions are defined as outstanding derivative contract or repo-style transactions that a banking organization or clearing member has entered into with a central counterparty (“CCP”). Although Basel II previously permitted exposures to a CCP arising from cleared transactions to be assigned an exposure amount of zero, in recognition of the fact that CCPs pose risk concentration and systemic risk concerns, the RWA NPR would require a banking organization to hold risk-based capital for an outstanding derivative or a repo-style transaction that has been entered into with all CCPs, including exchanges. A banking organization would be required to hold risk-based capital for all of its cleared transactions, regardless of whether the banking organization is acting as a clearing member or a clearing member client. However, a cleared transaction would not include “an exposure of a banking organization that is a clearing member to its clearing member client where the banking organization is either acting as a financial intermediary and enters into an offsetting transaction with a CCP or where the banking organization provides a guarantee to the CCP on the performance of the client.” More generally, despite the fact that the RWA NPR would impose capital requirements on transactions cleared through CCPs, the Proposals reflect a clear desire on the part of the Agencies to encourage the use of CCPs by financial institutions. As the Agencies note in the RWA NPR, the proposed capital requirements for transactions cleared by CCPs are “designed to incentivize the use of CCPs, help reduce counterparty credit risk, and promote strong risk management of CCPs to mitigate their potential for systemic risk.”<sup>17</sup>

### 1. Risk-Weighted Asset Amount for Clearing Member Clients and Clearing Members

Basel III provides that the risk-weighted asset amount for cleared transactions involving both derivative contracts and repo-style transactions will be calculated by adding the trade exposure amount calculated using the current exposure methodologies for OTC derivatives and the collateral haircut approach, respectively, to the fair value of the collateral posted by the clearing member. However, collateral that is bankruptcy-remote from the CCP will be offset against the trade exposure amount.

The risk weight of the ultimate exposure will depend on whether the CCP is a qualifying CCP (“QCCP”). Clearing member banking organizations would apply a two percent risk

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<sup>17</sup> RWA NPR at 45.

weight to exposure amounts with a QCCP. Clearing member clients would also apply a two percent risk weight to the trade exposure amount if they meet certain collateral loss prevention and sufficiency of legal review requirements. If the QCCP criteria were not met, a risk weight of four percent is applied to the trade exposure amount. In addition, collateral posted by a clearing member banking organization that is held by a custodian in a manner that is bankruptcy remote would not be subject to a capital requirement for counterparty credit risk.

## 2. Default Fund Contributions

The BCBS proposes to require that clearing members of CCPs calculate the risk-weighted asset amount for their default fund contributions at least quarterly. A 1,250 percent risk weight would be assigned to a banking organization's default fund contribution to a CCP that is not a QCCP. A three-step process would be used to calculate the risk-weighted asset amount for a default fund contribution to a QCCP. The first step would be to calculate the QCCP's hypothetical capital requirement. The second is to compare the QCCP to the funded portion of the default fund of a QCCP and calculate the total of all the clearing members' capital requirements. Finally, the total of all the clearing members' capital requirement is allocated back to each individual clearing member, proportional to each clearing member's contribution to the default fund, adjusted to reflect the impact of two average-size clearing members defaulting and to account for the concentration of exposure among clearing members.

## CREDIT RISK MITIGATION

The current risk-based capital rules provide for limited recognition of guarantees and collateral as credit risk mitigants. The RWA NPR expands the categories of eligible guarantors and eligible collateral in a manner generally consistent with Basel III. Guarantees and credit derivatives would be required to meet certain specified conditions in order to be recognized as credit risk mitigants. Eligible financial collateral would include: (i) cash on deposit with the banking organization; (ii) gold bullion; (iii) short- and long-term debt securities that are publicly traded; (iv) equity securities that are publicly traded; (v) convertible bonds that are publicly traded; and (vi) money market fund shares and other mutual fund shares if a price for the shares is publicly quoted daily.

Banking organizations would be able to recognize the risk-mitigating effects of collateral using a variety of methodologies, and would be required to adhere to specified guidance on risk management in order to recognize collateral for credit risk mitigation purposes. They would be permitted to use a collateral haircut approach with supervisory haircuts; they would

also be permitted to recognize their own estimates of haircuts with prior written approval of their primary federal supervisor. Under this approach, banking organizations could calculate exposure using either standard supervisory haircuts or its own estimates and risk weight the exposure amount based on the counterparty or guarantor. The value of the exposure amount would be calculated by summing the (i) value of the exposure less the value of the collateral; (ii) absolute value of the net position in a given instrument multiplied by the appropriate market price volatility haircut; and (iii) absolute values of the net position of the instruments and cash in a currency that is different from the settlement currency multiplied by the haircut appropriate to the currency mismatch (eight percent).

Importantly, for netting sets with large numbers of trades (over 5000) or illiquid collateral or OTC derivatives, the Standardized Approach NPR would require banking organizations to assume a holding period of 20 business days for the collateral under the collateral haircut approach. This fixes the Basel II approach, which proved inadequate during the financial crisis, insofar as it did not adequately reflect the delays and difficulties that financial institutions faced when settling out and closing collateralized transactions. In some cases, adjustments would be made if there have been over two margin disputes in the past two quarters on a netting set that lasted longer than the holding period, in which case the holding period will be multiplied by at least two. However, cleared transactions would not be subject to the upward holding period adjustment.

#### UNSETTLED TRANSACTIONS

Under the RWA NPR, separate risk-based capital requirements would attach to transactions involving securities, foreign exchange instruments and commodities that have a risk of delayed settlement or delivery. If, however, a system-wide failure of a settlement, clearing system or central counterparty occurred, a banking organization's primary federal supervisor would have the discretion to waive risk-based capital requirements for unsettled and failed transactions until the situation was rectified.

Separate treatments are suggested for delivery-versus-payment (DvP) and payment-versus-payment (PvP) transactions and non-DvP/non-PvP transactions with a normal settlement period. Banking organizations would hold risk-based capital against such transactions if they are not settled within five business days of the settlement date (for DvP/PvP transactions) or by the end of the business day on the settlement date (for non-DvP/non-PvP transactions). Risk weights up to 1,250 percent are assigned depending on how delayed the settlement is.

## RISK-WEIGHTED ASSETS FOR SECURITIZATION EXPOSURES

In the RWA NPR, the Agencies propose a new securitization framework, one intended to address the tranching of credit risk of financial exposures. The proposed framework contemplates a broader definition of a securitization exposure that encompasses a wider range of exposures with similar characteristics. The length of a required summary of the securitization provisions precludes a summary in this client update, although it may be separately addressed in a future Update.

## INSURANCE-RELATED ACTIVITIES

The Proposals would impose consolidated capital requirements on most BHCs and all U.S.-domiciled top-tier SLHCs. Many U.S. insurers are SLHCs by virtue of their direct or indirect control of a savings association; thus, the Proposals would impose consolidated capital requirements on many U.S. insurers for the first time.

Under the Proposals, BHCs and SLHCs engaged in insurance activities would generally be subject to consolidated capital requirements to the same extent as other BHCs and SLHCs, with certain modifications for activities and assets specific to insurers, such as policy loans, separate accounts and surplus notes. In the preamble to the RWA NPR, the Board discusses its approach to applying consolidated capital requirements to insurers. The Board states that in formulating the Proposals, it considered extensive comments from interested parties, such as insurance-centric SLHCs, in response to previous releases concerning the Board's new authority under Dodd-Frank to supervise SLHCs.<sup>18</sup> The Board states that it has reviewed and taken these comments into account, and believes that requiring BHCs and SLHCs engaged in insurance activities to adhere to the modified consolidated capital framework contemplated by the Proposals "appropriately take into consideration . . . unique characteristics, risks, and activities [of insurance companies] while ensuring compliance with the requirements of the Dodd-Frank Act."<sup>19</sup> Please see Appendix E for a more detailed explanation of the capital treatment of insurer-specific assets and activities under the

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<sup>18</sup> See, e.g., *Agency Information Collection Activities Regarding Savings and Loan Holding Companies: Announcement Board Approval Under Delegated Authority and Submission to OMB*, 76 Fed. Reg. 81,933 (December 29, 2011); *Agency Information Collection Activities: Submission for OMB Review; Comment Request (3064-0162)*, 76 Fed. Reg. 53,129 (August 25, 2011).

<sup>19</sup> RWA NPR at 95.

Proposals. As stated above, other than providing for consideration of insurer-specific assets, the Proposal otherwise would apply the same as with non-insurance-centric SLHCs.

#### MARKET DISCIPLINE AND DISCLOSURE REQUIREMENTS

In the preamble to the RWA NPR, the Agencies indicate their support for public disclosure to further market discipline and risk management practices. In the preamble to the RWA NPR, the Agencies also acknowledge the tension between the market benefits of the disclosure requirements and the burdens disclosure place on banking organizations.

Nevertheless, the Standardized Approach NPR would require a variety of enhanced public disclosures from banking organizations that have at least \$50 billion in total consolidated assets.<sup>20</sup> The required disclosures would address a variety of quantitative and qualitative factors relating to inter alia a banking organization's capital structure, adequacy and condition, credit risk, securitization activities and interest rate risk. Quantitative disclosures would be made quarterly, while qualitative disclosures would be made annually, as long as any major changes were disclosed in the interim.

#### The Advanced Approaches NPR

In the Advanced Approaches NPR, the Agencies propose to revise the advanced approaches rules to incorporate changes made by the BCBS since 2006, including changes made by Basel III. The Agencies also propose to revise the advanced approaches rules in light of section 939A of Dodd-Frank, which requires the removal of references to, or the requirements of reliance on, credit ratings from NRSROs. Unlike the prior two components of the Proposals, the Advanced Approaches NPR applies only to U.S. banking organizations with \$250 billion or more in total consolidated assets or on-balance-sheet exposures of \$10 billion or more.

#### COUNTERPARTY CREDIT RISK

The Advanced Approaches NPR would generally align the Agencies' advanced approaches rule with the Basel III framework, which contemplates specific amendments to the existing advanced approaches rule promulgated under Basel II.

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<sup>20</sup> This \$50 billion threshold is uniform with that of Title I of the Dodd-Frank Act, which requires that all U.S. banking organizations with \$50 billion or more in total consolidated assets be subject to enhanced regulatory requirements.

### 1. Revisions to the Recognition of Financial Collateral

The Advanced Approaches NPR would modify the definition of eligible financial collateral for purposes of calculating exposure-at-default (EAD) under the advanced approaches. Specifically, the NPR would modify the definition of eligible financial collateral such that re-securitizations would no longer qualify as eligible financial collateral under the advanced approaches rule. According to the Agencies, re-securitizations have proven to be relatively more volatile, and consequently less liquid, than other types of financial collateral. In addition, because the Agencies believe that securitization exposures have also experienced increased relative volatility, the Advanced Approaches NPR contemplates new standardized supervisory haircuts for securitization exposures based on the credit risk of the exposure.

Consistent with Basel III and the RWA NPR, the Advanced Approaches NPR would incorporate the 20 business day minimum assumed holding period and margin period of risk for the collateral haircut, simple VAR and IMM approaches. More specifically, in the case of 5000 trades during a quarter, or margin disputes, advanced institutions would need to make adjustments similar to those described in section II.D above.

### 2. Changes to Holding Periods and the Margin Period of Risk

The Agencies state in the preamble to the Advanced Approaches NPR that during the crisis “many financial institutions experienced significant delays in settling or closing-out collateralized transactions, including repo-style transactions and collateralized over-the-counter (OTC) derivatives.”<sup>21</sup> Consistent with Basel III, the Agencies propose to address this perceived deficiency by amending the advanced approaches rule to extend the required holding periods in the approaches to determining EAD.

### 3. Changes to the IMM

In the preamble, the Agencies state that during the crisis, “increased volatility in the value of derivative positions and collateral led to higher counterparty exposures than amounts estimated by banking organizations’ internal models.”<sup>22</sup> To address this issue, the Agencies propose to amend the internal models requirements of the advanced approaches rule to require advanced approaches institutions to determine capital requirements for counterparty

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<sup>21</sup> *Advanced Approaches NPR at 16.*

<sup>22</sup> *Id. at 14.*

credit risk using stressed inputs. Specifically, capital requirements for IMM exposures (arising from OTC derivatives, margin loans and repo transactions) would be equal to the larger of the capital requirement for those exposures calculated using data from the most recent three-year period, in addition to data from a three-year period that contained a period of stress reflected in the credit default spreads of the banking organizations' counterparties. Advanced approaches institutions would also be required to subject their internal models to an initial validation and annual model review process, and to have a comprehensive stress testing program that captures all credit exposures to counterparties and incorporates stress testing of principal market risk factors and the creditworthiness of counterparties.

The Agencies also propose to enhance requirements for the recognition and treatment of wrong-way risk in the IMM. Under the Advanced Approaches NPR, advanced approaches institutions would be required to implement risk management procedures to identify, monitor, and control wrong-way risk throughout the life of an exposure, including the use of stress testing and scenario analysis. Upon the identification of wrong-way risk, institutions would be required to make appropriate adjustments to their internal models.

Finally, in recognition of the correlation of financial institutions' creditworthiness attributable to similar sensitivities to common risk factors, the Advanced Approaches NPR would increase the correlation factor for (i) wholesale exposures to unregulated financial institutions by 25% for certain unregulated financial institutions and (ii) regulated financial institutions with consolidated assets greater than or equal to \$100 billion.

#### 4. Credit Valuation Adjustments

The Agencies state that during the financial crisis, only one third of counterparty credit risk losses resulted from actual defaults, with the other two thirds of losses attributable to mark-to-market losses from Credit Valuation Adjustments ("CVA"). To address this issue, Basel III includes an additional capital requirement to reflect CVA risk, and provides two approaches for calculating the CVA capital requirement: the simple and advanced approaches.

In the Advanced Approaches NPR, the Agencies propose to impose a higher counterparty credit risk capital requirement to account for CVA. The NPR would implement both the simple and advanced approaches contemplated by Basel III, but, pursuant to section 939A of Dodd-Frank, would do so without reference to credit ratings. An advanced approaches institution would be required to meet certain conditions and receive approval from its primary federal supervisor in order to utilize the advanced approaches.

## 5. Cleared Transactions

As discussed previously, the Agencies propose to increase capital requirements for institutions' exposures to CCPs. Consistent with the RWA NPR, the Agencies propose increasing the risk weighting (from zero to two or four percent depending on whether certain criteria are met) of advanced approaches institutions' trade exposures to certain QCCPs and applying a risk weighting to exposures to CCPs that are not QCCPs.

## 6. Stress Period for Internal Estimates

Under the collateral haircut approach in the current advanced approaches rule, banking organizations that receive prior approval from their primary federal supervisor may calculate market price and foreign exchange volatility using internal models. To receive approval for such an approach, advanced approaches institutions would be required to base own internal estimates on certain historical criteria, including a historical observation period of at least one year.

In the Advanced Approaches NPR, the Agencies propose to modify the quantitative standards governing the stress period for banking organizations' internal calculations. Advanced approaches institutions would be required to base internal estimate of haircuts on a historical observation period that reflected a continuous 12-month period of significant financial stress appropriate to the security or category of securities. The Agencies would retain the discretion to require an advanced approaches institution to use a different period of significant financial stress in the calculation of internal estimates.

## REMOVAL OF REFERENCES TO CREDIT RATINGS

Pursuant to section 939A of Dodd-Frank, the Advanced Approaches NPR proposes a number of changes to the definitions in the advanced approaches rules that reference credit ratings. Importantly, the NPR proposes to replace the use of credit ratings in certain provisions of the current advanced approaches rule with an "investment grade" standard that does not rely on credit ratings. "Investment grade" would be defined to mean that the entity to which the banking organization is exposed through a loan or security (or the reference entity with respect to a credit derivative) has adequate capacity to meet financial commitments for the projected life of the asset or exposure. An entity or reference entity would be deemed to have "adequate capacity to meet financial commitments" if the risk of its default is low and the full and timely repayment of principal and interest is expected.

## REVISIONS TO THE TREATMENT OF SECURITIZATION EXPOSURES

The Advanced Approaches NPR would remove from the advanced approaches rules the current ratings-based and internal assessment approaches for securitization exposures, and would adopt a revised framework for securitizations. Advanced approaches institutions would use either (i) a supervisory formula approach or (ii) a simplified supervisory formula approach to determine capital requirements for securitization exposures.

## TREATMENT OF EXPOSURES SUBJECT TO DEDUCTION

Under the current advanced approaches rule, an advanced approaches institution must deduct certain exposures from total capital. In the Advanced Approaches NPR, the Agencies propose that exposures currently deducted from total capital instead be assigned a 1,250 percent risk weight, subject to certain exceptions. According to the Agencies, the proposed change would reduce differences in the measure of Tier 1 capital for risk-based capital purposes under the advanced approaches rules, as compared to leverage capital requirements. The Agencies clarify that they are not proposing to apply a 1,250 percent risk weight to those exposures currently deducted from Tier 1 capital under the advanced approaches rule.

## ADDITIONAL AMENDMENTS

The Advanced Approaches NPR would amend the advanced approaches rules in certain other respects, including:

- Amending the definition of “eligible guarantee” to explicitly include a contingent obligation of the U.S. Government or an agency of the U.S. Government;
- Excluding assets held by insurance underwriting subsidiaries from the \$10 billion in total foreign exposures threshold for application of the advanced approaches rule;
- Replacing the term “local country claims” with the term “foreign-office claims” to comport the advanced approaches rule with changes to the FFIEC Country Exposure Report that occurred after the initial issuance of the advanced approaches rules;
- Clarifying that once an advanced approaches institution is subject to the advanced approaches rule, it would remain subject to the rule until its primary federal supervisor

- determined that application of the rule would not be appropriate in light of the banking organization's asset size, level of complexity, risk profile or scope of operations;
- Deleting the Pillar I seasoning provision, which required an upward adjustment to estimated PD for segments of retail exposures for which seasoning effects are material, and instead treating seasoning under Pillar 2;
  - Assigning a 20 percent risk-weight to cash items in the process of collection;
  - Modifying the definition of "Qualifying Revolving Exposure" (QRE), such that certain unsecured and unconditionally cancellable exposures where an advanced approaches institution consistently imposes in practice an upper limit of \$100,000 and requires payment in full every cycle will qualify as QRE; and
  - Removing the one-year maturity floor for trade finance instruments, consistent with 2011 BCBS revisions to the advanced approaches rules.

#### ENHANCED DISCLOSURE REQUIREMENTS

##### 1. Frequency and Timeliness of Exposures

Under the Advanced Approaches NPR, an advanced approaches institution would be required to provide, in a timely manner, certain qualitative and quantitative disclosures on a quarterly, or annual basis. An institution could use disclosures made pursuant to SEC, regulatory reporting, and other disclosure requirements to help meet these disclosure requirements. Further accommodations would be made in instances where an institution's fiscal year-end coincides with the end of a calendar quarter; in such cases, the requirement for timely disclosure would be no later than the applicable reporting deadlines for regulatory reports and financial reports. If deadlines differed, institutions would adhere to the later deadline. Where an institution's fiscal year-end does not coincide with the end of a calendar quarter, the Agencies would consider disclosures made within 45 days as timely.

##### 2. Enhanced Disclosure Requirements

As required under the RWA NPR, advanced approaches institutions would be required to provide detailed qualitative and quantitative disclosures concerning capital structure, capital adequacy, capital conservation and countercyclical buffers, credit and operational risk, and securitization activities. Institutions would be required to provide these disclosure on a quarterly (or in some cases, annual) basis; disclosures would also be required to be "timely."

### 3. Equity Holdings That Are Not Covered Positions

The advanced approaches rules currently require advanced approaches institutions to include in their public disclosures a discussion of important policies covering the valuation of and accounting for equity holdings in the banking book. In the Advanced Approaches NPR, the Agencies propose to refer to such exposures as equity holdings that are not covered positions.

#### MARKET RISK CAPITAL RULE

Simultaneously with the publication of the Proposals, the Agencies promulgated a separate rule finalizing revisions to the market risk capital rule. In the Advanced Approaches NPR, the Agencies propose to apply the market risk capital rule to savings associations and SLHCs. The market risk capital rule would apply to savings associations or SLHCs whose trading activity (*i.e.*, the gross sum of trading assets and liabilities) is equal to (i) 10 percent or more of its total assets or (ii) \$1 billion or more. The Agencies note that although savings associations and savings and loan holding companies “do not engage in trading to a substantial degree,” they believe that any savings association or SLHC whose trading activity grows to the extent that it meets the threshold for the market risk capital rule should “hold capital commensurate with the risk of the trading activity” and have in place “prudential risk management systems and processes required under the market risk capital rule.”<sup>23</sup>

The market risk capital rule will be described in greater detail in a future update.

#### Conclusion

Examined from a procedural point of view, the Proposals represent one of the first efforts by the Agencies to harmonize and integrate separate areas of law – including several Basel proposals and provisions of Dodd-Frank, such as the Collins Amendment, the Volcker Rule and the section 939A requirement not to rely on NRSROs. Unfortunately, however, the Proposals do not reflect any of the reduction of cumulative burdens that the banking industry hoped might result from a collective consideration of the multiple new requirements imposed on them over the past several years. Instead, in many respects, the Proposals seemingly go beyond what was required in the statutes, for example by applying heightened capital requirements, more quickly, to a broader range of banking organizations

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<sup>23</sup> *Advanced Approaches NPR at 42.*

than many thought likely, and giving little recognition to the different business models of many SLHCs.

The Proposals thus establish a discouraging precedent of adding rather than reducing burdens when multiple statutory regimes are involved, and doing so in an area absolutely fundamental to all activities and investments of banking organizations. Given the Basel Committee's June 11 "Report to G20 Leaders on Basel III Implementation,"<sup>24</sup> which portrays the U.S. as an international laggard in implementing the new capital framework, the industry cannot expect significant relief from the September 7 date for the receipt of comments on the Proposals. Extensive, thoughtful comment by the industry, and its trade groups, will be critical to seek to prevent regulatory action from causing the cumulative burdens on the industry to extend even beyond what was feared when the various laws and frameworks were viewed in isolation.

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<sup>24</sup> See *Bank for International Settlements, Report to G20 Leaders on Basel III Implementation (2012)*, available at <http://www.bis.org/publ/bcbs220.pdf>.

## **Appendices**

**Appendix A – Proposed Regulatory Capital Levels; Implementation Schedule**

**Appendix B – Implementation of the Capital Conservation and Countercyclical Capital Buffer**

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### Appendix A – Proposed Regulatory Capital Levels; Implementation Schedule

	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Capital conservation buffer				0.625%	1.25%	1.875%	2.5%
Minimum common equity tier 1 capital ratio + capital conservation buffer	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Minimum tier 1 capital ratio + capital conservation buffer	4.5%	5.5%	6.0%	6.625%	7.125%	7.875%	8.5%
Minimum total capital ratio + capital conservation buffer	8.0%	8.0%	8.0%	8.625%	9.125 %	9.875%	10.5%
Maximum potential countercyclical capital buffer				0.625%	1.25%	1.875%	2.5%

**Appendix B – Implementation of the Capital Conservation and Countercyclical Capital Buffer**

<b>Transition Period</b>	<b>Capital conservation buffer (assuming a countercyclical capital buffer of zero)</b>	<b>Maximum payout ratio (as a percentage of eligible retained income)</b>
<b>Calendar year 2016</b>	Greater than 0.625 percent	No payout ratio limitation applies
	Less than or equal to 0.625 percent, and greater than 0.469 percent	60 percent
	Less than or equal to 0.469 percent, and greater than 0.313 percent	40 percent
	Less than or equal to 0.313 percent, and greater than 0.156 percent	20 percent
	Less than or equal to 0.156 percent	0 percent
<b>Calendar year 2017</b>	Greater than 1.25 percent	No payout ratio limitation applies
	Less than or equal to 1.25 percent, and greater than 0.938 percent	60 percent
	Less than or equal to 0.938 percent, and greater than 0.625 percent	40 percent
	Less than or equal to 0.625 percent, and greater than 0.313 percent	20 percent
	Less than or equal to 0.313 percent	0 percent

<b>Calendar year 2018</b>	Greater than 1.875 percent	No payout ratio limitation applies
	Less than or equal to 1.875 percent, and greater than 1.406 percent	60 percent
	Less than or equal to 1.406 percent, and greater than 0.938 percent	40 percent
	Less than or equal to 0.938 percent, and greater than 0.469 percent	20 percent
	Less than or equal to 0.469 percent	0 percent

**Appendix C – A Comparison of Current and Proposed Prompt Corrective Action Levels**

Requirement		Total RBC measure (%)		Tier 1 RBC measure (%)		Common Equity Tier 1 RBC measure (%)		Leverage Measures			PCA Requirements (unchanged from current rule)
								Leverage ratio (%)		New supplementary leverage ratio (%) (Proposed for advanced approaches institutions only)	
Current	Proposed	Current	Proposed	Current	Proposed	Current	Proposed	Current	Proposed		
Well capitalized		≥ 10	≥ 10	≥ 6	≥ 8	N/A	≥ 6.5	≥ 5	≥ 5	N/A	None.
Adequately capitalized		≥ 8	≥ 8	≥ 4	≥ 6	N/A	≥ 4.5	≥ 4 (or ≥ 3)	≥ 4	≥ 3	May limit nonbanking activities at DP's FHC and includes limits on brokered deposits.
Undercapitalized		< 8	< 8	< 4	< 6	N/A	< 4.5	< 4 (or < 3)	< 4	< 3	Includes adequately capitalized restrictions, and also includes restrictions on asset growth; dividends; requires a capital plan.
Significantly Undercapitalized		< 6	< 6	< 3	< 4	N/A	< 3	< 3	< 3	N/A	Includes undercapitalized restrictions, and also includes restrictions on sub-debt payments.
Critically Undercapitalized		Tangible Equity (defined as Tier 1 Capital plus non-tier 1 perpetual preferred stock) to Total Assets ≤ 2								N/A	Generally receivership/conservatorship within 90 days.

**Appendix D – A Comparison of Current and Proposed Risk Weights**

Category	Current Risk Weight (in general)	Proposal	Comments
<b>Risk Weights for On-Balance Sheet Exposures Under Current and Proposed Rules</b>			
<b>Cash</b>	<b>0%</b>	<b>0%</b>	
Direct and unconditional claims on the U.S. government, its Agencies, and the Federal Reserve	0%	0%	
Claims on certain supranational entities and multilateral development banks	20%	0%	Claims on supranational entities include, for example, claims on the International Monetary Fund.
Cash items in the process of collection	20%	20%	
Conditional claims on the U.S. government	20%	20%	A conditional claim is one that requires the satisfaction of certain conditions, for example, servicing requirements.
Claims on government sponsored entities (GSEs)	20% 100% on GSE preferred stock (20% for national banks).	20% on exposures others than equity exposures.	
Claims on U.S. depository institutions and NCUA-insured credit unions	20% 100% risk weight for an instrument included in the depository	20% 100% risk weight for an instrument included in the depository institution's regulatory	Instruments included in the capital of the depository institution may be deducted or treated under the equities section below.

	institution's regulatory capital.	capital (unless that instrument is an equity exposure or is deducted).	
Claims on U.S. public sector entities (PSEs)	20% for general obligations. 50% for revenue obligations.	20% for general obligations. 50% for revenue obligations.	
Industrial development bonds	100%	100%	
Claims on qualifying securities firms	20% in general.	100% See commercial loans and corporate exposures to financial companies section below.	Instruments included in the capital of the securities firm may be deducted or treated under the equities section below.
1-4 family loans	50% if first lien, prudently underwritten, owner occupied or rented, current or <90 days past due. 100% otherwise.	<u>Category 1</u> : 35%, 50%, 75%, 100% depending on LTV. <u>Category 2</u> : 100%, 150%, 200% depending on LTV.	<u>Category 1</u> is defined to include first-lien mortgage products that meet certain underwriting characteristics. <u>Category 2</u> is defined to include junior-liens and mortgages that do not meet the category 1 criteria.
1-4 family loans modified under HAMP	50% and 100%. The banking organization must use the same risk weight assigned to the loan prior to the modification so long as the loan continues to meet other applicable prudential criteria.	35% to 200%. The banking organization must determine whether the modified terms make the loan a Category 1 or a Category 2 mortgage.	Under the RWA NPR (as under current rules) HAMP loans are not treated as restructured loans.
Loans to builders secured by 1-4 family properties presold under firm contracts	50% if the loan meets all criteria in the regulation; 100% if the contract is cancelled; 100% for loans not meeting the criteria.	50% if the loan meets all criteria in the regulation; 100% if the contract is cancelled; 100% for loans not meeting the criteria.	

Loans on multifamily properties	50% if the loan meets all the criteria in the regulation; 100% otherwise.	50% if the loan meets all the criteria in the regulation; 100% otherwise.	
Corporate exposures	100%	100%  However, if the exposure is an instrument included in the capital of the financial company, deduction treatment may apply.	
High volatility commercial real estate (HVCRE) loans	100%	150%	The proposed treatment would apply to certain facilities that finance the acquisition, development or construction of real property other than 1-4 family residential property.
Consumer loans	100%	100%	This is not a specific category under the RWA NPR. Therefore the default risk weight of 100% applies.
Past due exposures	Generally the risk weight does not change when the loan is past due.  However, 1-4 family loans that are past due 90 days or more are 100% risk weight.	150% for the portion that is not guaranteed or secured (does not apply to sovereign exposures or 1-4 family residential mortgage exposures).	
Assets not assigned to a risk weight category, including fixed assets, premises, and other real estate owned	100%	100%	
Claims on foreign governments and their central	0% for direct and unconditional claims on OECD governments; 20%	Risk weight depends on Country Risk Classification (CRC)	Under the current and proposed rules, a banking organization may apply a lower risk

banks	for conditional claims on OECD governments; 100% for claims on non-OECD governments that entail some degree of transfer risk.	applicable to the sovereign and ranges between 0% and 150%.  100% for sovereigns that do not have a CRC.  150% for a sovereign that has defaulted within the previous five years.	weight to an exposure denominated in the sovereign's own currency if the banking organization has at least an equivalent amount of liabilities in that currency.
Claims on foreign banks	20% for claims on banks in OECD countries.  20% for short-term claims on banks in non-OECD countries.  100% for long-term claims on banks in non-OECD countries.	Risk weight depends on home country's CRC rating and ranges between 20% and 50%.  100% for foreign bank whose home country does not have a CRC.  150% in the case of a sovereign default in the bank's home country.  100% for an instrument included in a bank's regulatory capital (unless that instrument is an equity exposure or is deducted).	Under the proposed rule, instruments included in the capital of a foreign bank would be deducted or treated under the equities section below.
Claims on foreign PSEs	20% for general obligations of states and political subdivisions of OECD countries.  50% for revenue obligations of states and political subdivisions of OECD countries.  100% for all obligations of states and	Risk weight depends on the home country's CRC and ranges between 20% and 150% for general obligations; and between 50% and 150% for revenue obligations.  100% for exposures to a PSE in a home country that does not have a	

	political subdivisions of non-OECD countries.	CRC; 150% for a PSE in a home country with a sovereign default.	
MBS, ABS, and structured securities	<p><u>Ratings Based Approach:</u></p> <p>20%: AAA &amp; AA.</p> <p>50%: A-rated.</p> <p>100%: BBB.</p> <p>200%: BB-rated.</p> <p>[Securitizations with short-term ratings – 20, 50, 100, and for unrated positions, where the banking organization determines the credit rating – 100 or 200].</p> <p><u>Gross-up approach:</u> the risk-weighted asset amount is calculated using the risk weight of the underlying assets amount of the position and the full amount of the assets supported by the position (that is, all of the more senior positions).</p> <p>Dollar for dollar capital for residual interests.</p> <p>Deduction for CEIO strips over concentration limit.</p> <p>100% for stripped MBS (IOs and Pos) that are not credit enhancing.</p>	<p>Deduction for the after-tax gain-on-sale of a securitization.</p> <p>1,250% risk weight for a CEIO;</p> <p>100% for interest-only MBS that are not credit-enhancing.</p> <p>Banking organizations may elect to follow a gross-up approach, similar to existing rules.</p> <p><u>SSFA:</u> the risk weight for a position is determined by a formula and is based on the risk weight applicable to the underlying exposures, the relative position of the securitization position in the structure (subordination), and measures of delinquency and loss on the securitized assets.</p> <p>1,250% otherwise.</p>	

Unsettled transactions	Not addressed.	<p>100%, 625%, 937.5%, and 1,250% for DvP or PvP transactions depending on the number of business days past the settlement date.</p> <p>1,250% for non-DvP, non-PvP transactions more than five days past the settlement date.</p> <p>The proposed capital requirement for unsettled transactions would not apply to cleared transactions that are marked-to-market daily and subject to daily receipt of variation margin.</p>	<p>DvP (delivery vs. payment) transaction means a securities or commodities transaction in which the buyer is obligated to make payment only if the seller has made delivery of the securities or commodities and the seller is obligated to deliver the securities or commodities only if the buyer has made the payment.</p> <p>PvP (payment vs. payment) transaction means a foreign exchange transaction in which each counterparty is obligated to make the final transfer of one or more currencies only if the other counterparty has made a final transfer of one or more currencies.</p>
Equity Exposures	100% of incremental deduction approach for nonfinancial equity investments.	<p>0% risk weight: equity exposures to a sovereign, certain supranational entities, or an MDB whose debt exposures are eligible for 0% risk weight.</p> <p>20%: Equity, exposures to a PSE, a FHLB, or Farmer Mac.</p> <p>100% Equity exposures to community development investments and small business investment companies and non-significant equity investments.</p> <p>250%: Significant investments in the capital of unconsolidated financial institutions that are not</p>	MDB = multilateral development bank.

		<p>deducted from capital pursuant to section 22.</p> <p>300%: Most publicly traded equity exposures.</p> <p>400%: Equity exposures that are not publicly traded.</p> <p>600%: Equity exposures to certain investment funds.</p>	
Equity exposures to investment funds	<p>There is a 20% risk weight floor on mutual fund holdings.</p> <p>General rule: Risk weight is the same as the highest risk weight investment the fund is permitted to hold.</p> <p>Option: A banking organization may assign risk weights pro rata according to the investment limits in the fund's prospectus.</p>	<p><u>Full look-through:</u> Risk weight the assets of the fund (as if owned directly) multiplied by the banking organization's proportional ownership in the fund.</p> <p><u>Simple modified look-through:</u> Multiply the banking organization's exposure by the risk weight of the highest risk weight asset in the fund.</p> <p><u>Alternative modified look-through:</u> Assign risk weight on a pro rata basis based on the investment limits in the fund's prospectus.</p> <p>For community development exposures, risk-weighted asset amount = adjusted carrying value.</p>	
<b>Credit Conversion Factors Under the Current and Proposed Rules</b>			

<p>Conversion Factors for off-balance sheet items</p>	<p>0% for the unused portion of a commitment with an original maturity of one year or less, or which is unconditionally cancellable at any time.</p> <p>10% for unused portions of eligible ABCP liquidity facilities with an original maturity of one year or less.</p> <p>20% for self-liquidating trade-related contingent items.</p> <p>50% for the unused portion of a commitment with an original maturity of more than one year that are not unconditionally cancellable.</p> <p>50% for transaction-related contingent items (performance bonds, bid bonds, warranties, and standby letters of credit).</p> <p>100% for guarantees, repurchase agreements, securities lending and borrowing transactions, financial standby letters of credit, and forward agreements.</p>	<p>0% for the unused portion of a commitment that is unconditionally cancellable by the banking organization.</p> <p>20% for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable.</p> <p>20% for self-liquidating trade-related contingent items.</p> <p>50% for the unused portion of a commitment over one year that are not unconditionally cancellable.</p> <p>50% for transaction-related contingent items (performance bonds, bid bonds, warranties, and standby letters of credit).</p> <p>100% for guarantees, repurchase agreements, securities lending and borrowing transactions, financial standby letters of credit, and forward agreements.</p>	
<p>Derivative contracts</p>	<p>Conversion to an on-balance sheet amount based on current exposure plus potential future exposure and a set of conversion factors.</p> <p><i>50% risk weight cap.</i></p>	<p>Conversion to an on-balance sheet amount based on current exposure plus potential future exposure and a set of conversion factors.</p> <p><i>No risk weight cap.</i></p>	

**Credit Risk Mitigation Under the Current and Proposed Rules**

<p>Guarantees</p>	<p>Generally recognizes guarantees provided by central governments, GSEs, PSEs in OECD countries, multilateral lending institutions, regional development banking organizations, U.S. depository institutions, foreign banks, and qualifying securities firms in OECD countries.</p> <p>Substitution approach that allows the banking organization to substitute the risk weight of the protection provider for the risk weight ordinarily assigned to the exposure.</p>	<p>Recognizes guarantees from eligible guarantors; sovereign entities, BIS, IMF, ECB, European Commission, FHLBs, Farmer Mac, a multilateral development bank, a depository institution, a bank holding company, a savings and loan holding company, a foreign bank, or an entity other than a SPE that has investment grade debt, whose creditworthiness is not positively correlated with the credit risk of the exposures for which it provides guarantees and is not a monoline insurer or re-insurer.</p> <p>Substitution treatment allows the banking organization to substitute the risk weight of the protection provider for the risk weight ordinarily assigned to the exposure. Applies only to eligible guarantees and eligible credit derivatives, and adjusts for maturity mismatches, currency mismatches, and where restructuring is not treated as a credit event.</p>	<p>Claims conditionally guaranteed by the U.S. government receive a risk weight of 20 percent under the standardized approach.</p>
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<p>Collateralized transactions</p>	<p>Recognize only cash on deposit, securities issued or guaranteed by OECD countries, securities issued or guaranteed by the U.S. government or a U.S. government agency, and securities issued by certain multilateral development banks.</p> <p>Substitute risk weight of collateral for risk weight of exposure, sometimes with a 20% risk weight floor.</p>	<p>For financial collateral only, the RWA NPR provides two approaches:</p> <ol style="list-style-type: none"> <li>1. <u>Simple approach</u>: A banking organization may apply a risk weight to the portion of an exposure that is secured by the market value of collateral by using the risk weight of collateral—with a general risk weight floor of 20%.</li> <li>2. <u>Collateral haircut approach</u> using standard supervisory haircuts or own estimates of haircuts for eligible margin loans, repo-style transactions, collateralized derivative contracts.</li> </ol>	<p><u>Financial collateral</u>: cash on deposit at the banking organization (or third party custodian); gold; investment grade securities (excluding re-securitizations); publicly traded convertible bonds; money market mutual fund shares; and other mutual fund shares if a price is quoted daily. In all cases the banking organization must have a perfected, first priority interest.</p> <p>For the simple approach there must be a collateral agreement for at least the life of the exposure; collateral agreement for at least the life of the exposure; collateral must be revalued at least every six months; collateral other than gold must be in the same currency.</p>
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Appendix E – Capital Treatment of Insurance-Specific Assets and Activities

Asset/Activity	Definition	Capital Treatment
Insurance underwriting subsidiaries	An insurance underwriting subsidiary of a BHC or SLHC.	BHCs and SLHCs would be required to deduct the minimum regulatory capital requirement of insurance underwriting subsidiaries (generally 200 percent of the subsidiary’s authorized control level as established by the appropriate state insurance regulator) from total capital. The deduction would be 50 percent from tier 1 capital and 50 percent from tier 2 capital.
Policy Loans	A loan to policyholders under the provisions of an insurance contract that is secured by the cash surrender value or collateral assignment of the related policy or contract.	Risk weighted at 20 percent.
Separate Accounts	<p>A legally segregated pool of assets owned and held by an insurance company and maintained separately from its general account assets for the benefit of individual contract holders. The account must meet the following additional conditions in order to be deemed a separate account:</p> <ol style="list-style-type: none"> <li>1. the account must be legally recognized under applicable law;</li> <li>2. the assets in the account must be insulated from the general liabilities of the insurance company and protected from the insurance company’s general creditors in the event of the insurer’s insolvency;</li> <li>3. the insurance company must invest the funds within</li> </ol>	

Asset/Activity	Definition	Capital Treatment
	<p>the account as directed by the contract holder in designated investment alternatives or in accordance with specific investment objectives or policies; and</p> <p>4. all investment performance, net of contract fees and assessments, must be passed through to the contract holder, provided that contracts may specify conditions under which there may be a minimum guarantee, but not a ceiling.</p>	
Non-guaranteed separate accounts	<p>Any separate account that meets the above definition and the following additional conditions:</p> <p>1. the insurance company does not guarantee a minimum return or account value to the contract holder; and</p> <p>2. the insurance company is not required to hold reserves for these separate account assets pursuant to its contractual obligations on an associated policy.</p>	Non-guaranteed separate account assets would be risk-weighted at zero percent.
Guaranteed Separate Accounts	Any separate account that meets the above definition and is not a non-guaranteed separate account.	Assigned to risk-weight categories based on the risk weight of the underlying asset.
Deferred Acquisition Costs (DAC)	Costs incurred in the acquisition of a new contract or renewal insurance contract that are capitalized pursuant to GAAP.	Risk weighted at 100 percent.
Value of Business Acquired (VOBA)	Assets that reflect revenue streams from insurance policies purchased by an insurance company.	Risk weighted at 100 percent.
Surplus Notes	A financial instrument issued by an insurance company that is included in surplus for statutory accounting purposes as prescribed or permitted by state laws and	Surplus notes would be ineligible for treatment as tier 1 capital, but could be eligible for inclusion in tier 2 capital if the

Asset/Activity	Definition	Capital Treatment
	<p>regulations. A surplus note would generally have the following features:</p> <ol style="list-style-type: none"><li data-bbox="632 435 1318 495">1. The applicable state insurance regulator approves in advance the form and content of the note;</li><li data-bbox="632 521 1318 613">2. The instrument is subordinated to policyholders, to claimant and beneficiary claims, and to all other classes of creditors other than surplus note holders; and</li><li data-bbox="632 639 1318 732">3. the applicable state insurance regulator is required to approve in advance any interest payments and principal repayments on the instrument.</li></ol>	<p>surplus note meets the generally applicable tier 2 capital eligibility criteria.</p>