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Comptroller of the Currency  
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US Department of the Treasury

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OCC 2011-50

**Subject: Capital Policy-Market Risk Capital Rules**  
**Date: December 29, 2011**

**To: Chief Executive Officers of All National Banks and Federal Savings Associations, Federal Branches and Agencies, Department and Division Heads, and All Examining Personnel**

## Description: Notice of Proposed Rulemaking

### Summary

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (the agencies) are seeking comment on a notice of proposed rule making (NPR) that would revise their market risk capital rules.

The NPR, which amends an interagency NPR published January 11, 2011 (January 2011 NPR), includes alternative standards of creditworthiness to be used in place of credit ratings to determine the capital requirements for certain debt and securitization positions covered by the market risk capital rules.

The proposed creditworthiness standards include the use of country risk classifications published by the Organization for Economic Cooperation and Development for sovereign positions; company-specific data related to leverage, cash flow, and the volatility of the company's monthly stock market returns for corporate debt positions; and a supervisory formula for securitization positions.

### Background

The January 2011 NPR proposed modifications to the agencies' market risk capital rules that were largely based on revisions to the market risk framework published by the Basel Committee on Banking Supervision since 2005. The January 2011 NPR, however, did not include aspects of the Basel Committee revisions that rely on credit ratings because, under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, all federal agencies must remove references to, and requirements of, reliance on credit ratings from their regulations and replace them with appropriate alternatives for evaluating creditworthiness.

This is the first proposal in which the agencies have proposed to replace references to credit ratings in their respective risk-based capital regulations. The agencies also expect to propose to replace references to credit ratings in their general risk-based capital regulations and the advanced approaches risk-based capital regulations in the coming months.

The OCC's current market risk capital rule (12 CFR 3, appendix B) applies to national banks for which (1) the sum of the bank's trading assets and liabilities is at least 10 percent of total assets, (2) the sum of the bank's trading assets and liabilities is at least \$1 billion, or (3) an election to apply the market risk rule has been made. Neither the January 2011 NPR nor the current NPR changes the scope of application of the rule.

The NPR was published in the *Federal Register* on December 21, 2011. Comments on the proposal are due on or before February 3, 2012.

### Further Information

You may direct questions or comments to Mark Ginsberg, Risk Expert, Capital Policy Division, at (202) 874-5070; or Carl Kaminski, Senior Attorney, Legislative and Regulatory Affairs Division, at (202) 874-5405.

John Lyons  
Senior Deputy Comptroller and Chief National Bank Examiner

**Related Link**

- [Notice of Proposed Rulemaking \(PDF\)](#)

RESCINDED

**DEPARTMENT OF THE TREASURY****Office of the Comptroller of the Currency****12 CFR Part 3**

[Docket ID OCC–2010–0003]

RIN 1557–AC99

**FEDERAL RESERVE SYSTEM****12 CFR Parts 208 and 225**

[Regulations H and Y; Docket No. R–1401]

RIN 7100–AD61

**FEDERAL DEPOSIT INSURANCE CORPORATION****12 CFR Part 325**

RIN 3064–AD70

**Risk-Based Capital Guidelines: Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions**

**AGENCIES:** Office of the Comptroller of the Currency, Department of the Treasury; Board of Governors of the Federal Reserve System; and Federal Deposit Insurance Corporation.

**ACTION:** Notice of proposed rulemaking (NPR).

**SUMMARY:** The Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), and Federal Deposit Insurance Corporation (FDIC) (collectively, the agencies) are seeking comment on an amendment to the notice of proposed rulemaking (NPR) to modify the agencies' market risk capital rules, published in the **Federal Register** on January 11, 2011 (January 2011 NPR). The January 2011 NPR did not include the methodologies adopted by the Basel Committee on Banking Supervision (BCBS) for calculating the standard specific risk capital requirements for certain debt and securitization positions, because the BCBS methodologies generally rely on credit ratings. Under section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act), all federal agencies must remove references to and requirements of reliance on credit ratings from their regulations and replace them with appropriate alternatives for evaluating creditworthiness. In this NPR, the agencies are proposing to incorporate into the proposed market risk capital rules certain alternative methodologies for calculating specific risk capital requirements for debt and securitization positions that do not rely on credit

ratings. The agencies expect to finalize this proposal, together with the January 2011 NPR, in the coming months after receipt and consideration of comments.

**DATES:** Comments on this notice of proposed rulemaking must be received by February 3, 2012.

**ADDRESSES:** Comments should be directed to:

*OCC:* Because paper mail in the Washington, DC area and at the Agencies is subject to delay, commenters are encouraged to submit comments by the Federal eRulemaking Portal or email, if possible. Please use the title "Risk-Based Capital Guidelines: Market Risk" to facilitate the organization and distribution of the comments. You may submit comments by any of the following methods:

- *Federal eRulemaking Portal—“regulations.gov”:* Go to <http://www.regulations.gov>. Select “Document Type” of “Proposed Rules,” and in “Enter Keyword or ID Box,” enter Docket ID “OCC–2010–0003,” and click “Search.” On “View By Relevance” tab at bottom of screen, in the “Agency” column, locate the proposed rule for OCC, in the “Action” column, click on “Submit a Comment” or “Open Docket Folder” to submit or view public comments and to view supporting and related materials for this rulemaking action.

- Click on the “Help” tab on the Regulations.gov home page to get information on using Regulations.gov, including instructions for submitting or viewing public comments, viewing other supporting and related materials, and viewing the docket after the close of the comment period.

- *Email:* [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov).

- *Mail:* Office of the Comptroller of the Currency, 250 E Street SW., Mail Stop 2–3, Washington, DC 20219.

- *Fax:* (202) 874–5274.

- *Hand Delivery/Courier:* 250 E Street SW., Mail Stop 2–3, Washington, DC 20219.

*Instructions:* You must include “OCC” as the agency name and “Docket ID OCC–2010–0003” in your comment. In general, OCC will enter all comments received into the docket and publish them on the Regulations.gov Web site without change, including any business or personal information that you provide such as name and address information, email addresses, or phone numbers. Comments received, including attachments and other supporting materials, are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that

you consider confidential or inappropriate for public disclosure.

You may review comments and other related materials that pertain to this proposed rule by any of the following methods:

- *Viewing Comments Electronically:* Go to <http://www.regulations.gov>. Select “Document Type” of “Public Submissions,” in “Enter Keyword or ID Box,” enter Docket ID “OCC–2010–0003,” and click “Search.” Comments will be listed under “View By Relevance” tab at bottom of screen. If comments from more than one agency are listed, the “Agency” column will indicate which comments were received by the OCC.

- *Viewing Comments Personally:* You may personally inspect and photocopy comments at the OCC, 250 E Street SW., Washington, DC. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling (202) 874–4700. Upon arrival, visitors will be required to present valid government-issued photo identification and to submit to security screening in order to inspect and photocopy comments.

- *Docket:* You may also view or request available background documents and project summaries using the methods described above.

*Board:* You may submit comments, identified by Docket No. R–[1401], by any of the following methods:

- *Agency Web Site:* <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.

- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments.

- *Email:* [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov).

Include docket number in the subject line of the message.

- *Fax:* (202) 452–3819 or (202) 452–3102.

- *Mail:* Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue NW., Washington, DC 20551.

All public comments are available from the Board's Web site at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper form in Room MP–500 of the Board's Martin Building (20th and C Street NW.) between 9 a.m. and 5 p.m. on weekdays.

FDIC: You may submit comments by any of the following methods:

- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments.

- *Agency Web site:* <http://www.FDIC.gov/regulations/laws/federal/propose.html>.

- *Mail:* Robert E. Feldman, Executive Secretary, Attention: Comments/Legal ESS, Federal Deposit Insurance Corporation, 550 17th Street NW., Washington, DC 20429.

- *Hand Delivered/Courier:* The guard station at the rear of the 550 17th Street Building (located on F Street), on business days between 7 a.m. and 5 p.m.

- *Email:* [comments@FDIC.gov](mailto:comments@FDIC.gov).

*Instructions:* Comments submitted must include "FDIC" and "RIN 3064-AD70." Comments received will be posted without change to <http://www.FDIC.gov/regulations/laws/federal/propose.html>, including any personal information provided.

**FOR FURTHER INFORMATION CONTACT:**

*OCC:* Mark Ginsberg, Risk Expert, (202) 927-4580, Roger Tufts, Senior Economic Advisor, Capital Policy Division, (202) 874-5070; or Carl Kaminski, Senior Attorney, Legislative and Regulatory Activities Division, (202) 874-5090, Office of the Comptroller of the Currency, 250 E Street SW., Washington, DC 20219.

*Board:* Anna Lee Hewko, Assistant Director, (202) 530-6260, Tom Boemio, Manager, (202) 452-2982, Connie Horsley, Manager, (202) 452-5239, Division of Banking Supervision and Regulation; or April C. Snyder, Senior Counsel, (202) 452-3099, or Benjamin W. McDonough, Senior Counsel, (202) 452-2036, Legal Division. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), (202) 263-4869.

*FDIC:* Bobby R. Bean, Associate Director, Capital Markets Branch, (202) 898-6705; Ryan Billingsley, Chief (Acting), Policy Section, (202) 898-3797; Karl Reitz, Senior Policy Analyst, (202) 898-6775, Division of Risk Management Supervision; or Mark Handzlik, Counsel, (202) 898-3990; or Michael Phillips, Counsel, (202) 898-3581, Supervision Branch, Legal Division.

**SUPPLEMENTARY INFORMATION:**

**I. Introduction**

This NPR amends the January 2011 NPR and solicits public comment on proposed methodologies for calculating the specific risk capital requirements for covered debt and securitization positions under the market risk capital rules. Specific risk relates to changes in

the market value of a position due to factors other than general market movements. The proposed methodologies would result in specific risk capital requirements for debt and securitization positions that are generally consistent with the BCBS's market risk framework, which relies on the use of credit ratings. The agencies expect to finalize this proposal, together with the January 2011 NPR, in the coming months after receipt and consideration of comments.

*A. January 2011 NPR*

The January 2011 NPR requested comment on a proposal to implement various revisions to the market risk framework adopted by the BCBS<sup>1</sup> between July 2005 and June 2010. The revisions would significantly modify the agencies' market risk capital rules<sup>2</sup> to better capture those positions for which application of the market risk capital rules are appropriate, address shortcomings in the modeling of certain risks, address procyclicality concerns, enhance the rules' sensitivity to risks that are not adequately captured under the current regulatory capital measurement methodologies, and increase transparency through enhanced disclosures.<sup>3</sup>

The January 2011 NPR was based on the *International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Basel II or New Accord)*,<sup>4</sup> and revisions thereto included in *The Application of Basel II to Trading Activities and the Treatment of Double Default Effects*, published jointly by the International Organization of Securities Commissions and the BCBS in 2005 (2005 revisions),<sup>5</sup> as well as revisions developed by the BCBS and published in three documents in July 2009: *Revisions to the Basel II Market Risk Framework*,<sup>6</sup> *Guidelines for Computing*

<sup>1</sup> The BCBS is a committee of banking supervisory authorities, which was established by the central bank governors of the G-10 countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. Documents issued by the BCBS are available through the Bank for International Settlements Web site at <http://www.bis.org>.

<sup>2</sup> 12 CFR Part 3, appendix B (OCC), 12 CFR parts 208 and 225, appendix E (Board), and 12 CFR part 325, appendix C (FDIC).

<sup>3</sup> 76 FR 1890 (Jan. 11, 2011).

<sup>4</sup> Available at, <http://www.bis.org/publ/bcbs107.htm>.

<sup>5</sup> Available at, <http://www.bis.org/publ/bcbs111.htm>.

<sup>6</sup> Available at, <http://www.bis.org/publ/bcbs193.htm>.

*Capital for Incremental Risk in the Trading Book*,<sup>7</sup> and *Enhancements to the Basel II Framework*<sup>8</sup> (collectively, the 2009 revisions). In June 2010, the BCBS published additional revisions to the market risk framework that included establishing a floor on the risk-based capital requirement for modeled correlation trading positions.<sup>9</sup>

Both the 2005 and 2009 revisions include provisions that reference credit ratings. In particular, the 2005 revisions provide for the use of credit ratings to determine the specific risk add-on for a debt position that is a covered position under the standardized measurement method. The 2005 and 2009 revisions also expand the "government" category of debt positions to include all sovereign debt and change the specific risk-weighting factor for sovereign debt from zero percent to a range of zero to 12.0 percent based on the credit rating of the obligor and the remaining contractual maturity of the debt position.<sup>10</sup>

The 2009 revisions include changes to the specific risk-weighting factors for rated and unrated securitization positions. For rated securitization positions, the revisions assign a specific risk-weighting factor based on the credit rating of a position, and whether such rating represents a long-term credit rating or a short-term credit rating. In addition, the 2009 revisions provide for the application of higher specific risk-weighting factors to rated re-securitization positions relative to similarly-rated securitization exposures. Under the 2009 revisions, unrated positions were to be deducted from total capital, except when the unrated position was held by a bank<sup>11</sup> that had approval to use the supervisory formula approach to determine the specific risk add-on for the unrated position, when the bank had approval to use an approach that used estimates in line

<sup>7</sup> Available at, <http://www.bis.org/publ/bcbs159.htm>.

<sup>8</sup> Available at, <http://www.bis.org/publ/bcbs/basel2enh0901.htm>.

<sup>9</sup> The June 2010 revisions can be found in their entirety at <http://www.bis.org/press/p100618/annex.pdf>.

<sup>10</sup> In the context of the market risk capital rules, the specific risk-weighting factor is a scaled measure that is similar to the "risk weights" used in the general risk-based capital regulations (*i.e.*, the zero, 20 percent, 50 percent, and 100 percent risk weights) for determining risk-weighted assets. The measure for market risk proposed under the January 2011 NPR is multiplied by 12.5 to convert it to market risk equivalent assets, which are then added to the denominator of the risk-based capital ratio.

<sup>11</sup> For simplicity, and unless otherwise indicated, the preamble to this notice of proposed rulemaking uses the term "bank" to include banks and bank holding companies (BHCs). The terms "bank holding company" and "BHC" refer only to bank holding companies regulated by the Board.

with the quantitative standards under the advanced approaches rule, or when the bank holding the unrated position elected to use the concentration ratio approach to calculate the specific risk add-on. Under *Basel III: A global regulatory framework for more resilient banks and banking systems* (Basel III), published by the BCBS in December 2010, and revised in June 2011, certain items, including certain securitization positions, that had been deducted from total capital are assigned a risk weight of 1,250 percent.

#### B. Development of Alternative Methodologies

Section 939A of the Act requires federal agencies to remove from their regulations any reference to or requirement of reliance on credit ratings in the assessment of creditworthiness of a security or money market instrument. Section 939A further requires the agencies to substitute in such regulations a standard of creditworthiness that the agencies determine to be appropriate in consideration of the entities regulated by each such agency and the purposes for which such entities would rely on such standards of creditworthiness.

In view of the requirements of section 939A, when publishing the January 2011 NPR, the agencies decided not to propose to implement those aspects of the 2005 and 2009 revisions that rely on the use of credit ratings. Instead, the January 2011 NPR included as a placeholder the treatment under the agencies' current market risk capital rules for determining the specific risk add-ons for debt and securitization positions. The agencies acknowledged the shortcomings of the current treatment and recognized that the treatment would need to be amended in accordance with the requirements of section 939A.

As part of their coordinated effort to implement the requirements of section 939A, on August 25, 2010, the agencies published a joint advance notice of proposed rulemaking (ANPR)<sup>12</sup> seeking comment on alternative creditworthiness standards for those provisions of the agencies' risk-based capital rules that currently reference credit ratings. The agencies received 23 comments on the ANPR from banks, industry and consumer advocacy groups, and individuals.

Most commenters shared a general concern regarding the removal of credit

ratings from the risk-based capital rules and asserted that credit ratings can be a valuable tool for assessing creditworthiness. These commenters also stated that any alternative creditworthiness standard used for the purposes of the risk-based capital rules should be risk sensitive so as to not incent banks to engage in regulatory arbitrage.

A number of commenters stated that section 939A permits the use of credit ratings as a supplement to prudent due diligence reviews. Other commenters asserted generally that a legislative change should be enacted that would amend section 939A to permit the agencies to continue using credit ratings in their regulations. These commenters stated that developing a suitable alternative to credit ratings would be impossible without creating undue regulatory burden, which would be particularly acute for community banks. Many commenters expressed concern that a risk-sensitive methodology to replace reliance on credit ratings requiring extensive modeling capabilities would disproportionately burden community and regional banks. According to these commenters, community and regional banks generally do not have the internal systems and staff capable of performing a level of analysis similar to that performed by credit rating agencies, and thus would have to hire third-party vendors.

Some commenters also stated that any alternative could result in inconsistencies with the international capital standards established by the BCBS that could place U.S. banks at a competitive disadvantage relative to non-U.S. banks. Other commenters stated that exclusive reliance on credit ratings is inappropriate, especially for securitization exposures for which measuring risk requires consideration of specific cash flow structures, collateral, and other enhancements.

Following the release of the ANPR, on November 10, 2010, the Board hosted a roundtable discussion attended by staff and principals of the agencies, as well as bankers, academics, asset managers, staff of credit rating organizations, and others to discuss alternative measures of creditworthiness. The roundtable participants reiterated many of the concerns expressed by commenters in response to the joint ANPR.<sup>13</sup>

#### C. Objectives of the Proposed Revisions

Since the publication of the ANPR and the January 2011 NPR, the agencies have been working to develop appropriate alternative creditworthiness standards to comply with section 939A of the Act. As indicated in the ANPR, the agencies believe that any alternative creditworthiness standard should, to the extent possible:

- Appropriately distinguish the credit risk associated with a particular exposure within an asset class;
- Be sufficiently transparent, unbiased, replicable, and defined to allow banking organizations of varying size and complexity to arrive at the same assessment of creditworthiness for similar exposures and to allow for appropriate supervisory review;
- Provide for the timely and accurate measurement of negative and positive changes in creditworthiness;
- Minimize opportunities for regulatory capital arbitrage;
- Be reasonably simple to implement and not add undue burden on banking organizations; and,
- Foster prudent risk management.

In developing alternative creditworthiness standards in this NPR, the agencies strove to incorporate as many of these features as possible and to establish capital requirements comparable to those published in the 2005 and 2009 revisions to ensure international consistency and competitive equity.

While this NPR concerns the market risk capital rules, the agencies believe that it is important to align the methodologies for calculating specific risk-weighting factors for debt positions and securitization positions in the market risk capital rules with methodologies for assigning risk weights under the agencies' other capital rules. Such alignment would reduce the potential for regulatory arbitrage between rules. Accordingly, the agencies intend to propose, at a later date, to revise their general risk-based capital rules<sup>14</sup> by incorporating creditworthiness standards for debt and securitization positions similar to the standards included in this proposal. Table 1 shows areas in the agencies' current and proposed risk-based capital standards that make reference to credit ratings.

<sup>12</sup> 75 FR 52283 (August 24, 2010).

<sup>13</sup> A detailed summary of the views expressed at the roundtable discussion is available at: [http://www.federalreserve.gov/newsevents/files/credit\\_ratings\\_roundtable\\_20101110.pdf](http://www.federalreserve.gov/newsevents/files/credit_ratings_roundtable_20101110.pdf).

<sup>14</sup> The agencies' general risk-based capital rules are at 12 CFR part 3, Appendix A (OCC); 12 CFR

part 208, Appendix A and 12 CFR part 225, Appendix A (Board); and 12 CFR part 325, Appendix A (FDIC).

TABLE 1—REFERENCES TO AND USE OF CREDIT RATINGS UNDER THE AGENCIES' CURRENT CAPITAL RULES AND BCBS STANDARDS

Exposure category	Agencies' capital rules			BCBS standards	
	General risk-based capital rule	Market risk amendment 1996	Advanced approaches rule	Basel II standardized approach	Basel market risk framework
1. Sovereign .....	.....	X	.....	X	X
2. Multilateral Development Banks .....	.....	X	.....	X	X
3. Public Sector Entity .....	.....	X	.....	X	X
4. Bank .....	.....	.....	.....	X	X
5. Corporate .....	X <sup>15</sup>	X	.....	X	X
6. Securitization .....	X	X	X	X	X

## II. The Proposed Rule

### A. Specific Risk Treatment Under the Agencies' Market Risk Capital Rules

Specific risk relates to changes in the market value of a position due to factors other than general market movements. For example, general market risk arises from changes in the level of interest rates on Treasury securities, from changes in the credit spreads for all borrowers of similar credit quality, and from changes in foreign exchange rates. These general market risk factors affect the value of all positions in a bank's trading account that are driven by changes in interest rates, foreign exchange rates, or equity and commodity prices. In contrast, specific risk refers to factors that apply singularly to an identified position. For example, idiosyncratic credit risk associated with a particular issuer of a debt instrument—which makes the holder of that instrument vulnerable to losses due to the credit quality deterioration of the issuer, or its declaration of bankruptcy—is specific risk.

Under the market risk capital rules, a bank may use an internal model to measure its exposure to specific risk if it has demonstrated to its primary federal supervisor that the model adequately measures the specific risk of its debt and equity positions. If a bank does not model specific risk, it must calculate its specific risk capital requirement, or "add-on" using a standardized method.<sup>15</sup> Under this method, the specific risk add-on for debt and securitization positions is calculated by multiplying the absolute value of the current market value of

each net long and net short position in a debt instrument by the appropriate specific risk-weighting factor that is specified in the rule. These specific risk-weighting factors range from zero to 8.0 percent and are based on the identity of the obligor and, in the case of some positions, the credit rating and remaining contractual maturity of the position. The specific risk add-on for a derivative instrument is based on the market value of the effective notional amount of the underlying position. A bank may net long and short debt positions (including derivatives) in identical debt issues or indices. A bank may also offset a "matched" position in a derivative and its corresponding underlying instrument.

Under the standardized method, the specific risk add-on for equity positions is the sum of the bank's net long and short positions in an equity position, multiplied by a specific risk-weighting factor. A bank may net long and short positions (including derivatives) in identical equity issues or equity indices in the same market. The specific risk add-on is 8.0 percent of the net equity position, unless the bank's portfolio is both liquid and well-diversified, in which case the specific risk add-on is 4.0 percent. For positions that are index contracts comprising a well-diversified portfolio of equities, the specific risk add-on is 2.0 percent of the net long or net short position in the index.

### B. Overview of the Proposed Revisions

This rulemaking sets forth methodologies for calculating specific risk capital requirements for debt and securitization positions under the agencies' proposed market risk capital rule that do not include references to credit ratings. To the extent feasible, the agencies have calibrated the capital requirements produced under these methodologies to be broadly consistent with the capital requirements under the Basel standardized measurement method for specific risk. While it is not possible to fully align these capital

requirements without referencing credit ratings, the agencies believe that the capital requirements under the proposed methodologies generally would be comparable to those produced by the BCBS's standardized measurement method.

*Question 1. The agencies recognize that any measure of creditworthiness likely will involve tradeoffs between more refined differentiation of risk and greater implementation burden. Do the proposed revisions described below strike an appropriate balance between measurement of risk and implementation burden in considering alternative measures of creditworthiness? Are there other alternatives permissible under section 939A of the Act that strike a more appropriate balance?*

Together with the new specific risk capital requirements, the agencies have included in this proposal a number of definitions relevant to the specific risk requirements proposed in this NPR.

#### 1. Sovereign Debt Positions

##### Background

The specific risk-weighting factors for sovereign debt positions in the current market risk capital rules are based on the membership of the sovereign entity in the Organization for Economic Cooperation and Development (OECD). Covered debt positions that are exposures to sovereign entities that are OECD members receive a zero percent specific risk-weighting factor, whereas exposures to sovereign entities that are non-OECD members receive an 8.0 percent specific risk-weighting factor. The general risk-based capital rules assign risk weights to credit exposures using the same OECD/non-OECD distinction. Under the 2005 revisions, sovereign positions would be assigned specific risk-weighting factors based on a given sovereign's external credit rating.

<sup>15</sup> Credit ratings are used in the determination of whether a securities firm is deemed a qualified securities firm for purposes of the general risk-based capital rule.

<sup>16</sup> See section 5(c) of the agencies' market risk capital rules for a description of this method. 12 CFR part 3, appendix B, section 5(c) (OCC); 12 CFR parts 208 and 225, appendix E, section 5(c) (Board); 12 CFR part 325, appendix C, section 5(c) (FDIC).

Table 2 provides the specific risk-weighting factors for sovereign debt positions under the 2005 revisions.

TABLE 2—BCBS SPECIFIC RISKWEIGHTING FACTORS FOR SOVEREIGN DEBT POSITIONS UNDER THE 2005 REVISIONS

External credit rating	Remaining contractual maturity	Specific risk-weighting factor (in percent)
Highest investment grade to second highest investment grade (for example, AAA to AA–).	.....	0.00
Third highest investment grade to lowest investment grade (for example, A+ to BBB–).	Residual term to final maturity 6 months or less .....	0.25
	Residual term to final maturity greater than 6 and up to and including 24 months.	1.00
	Residual term to final maturity exceeding 24 months .....	1.60
One category below investment grade to two categories below investment grade (for example, BB+ to B–).	.....	8.00
More than two categories below investment grade .....	.....	12.00
Unrated .....	.....	8.00

### Proposed Approach to Sovereign Debt Positions

Under this NPR, “sovereign debt position” would be defined as a direct exposure to a sovereign entity. Consistent with the January 2011 proposal, sovereign entity is defined as a central government or an agency, department, ministry, or central bank of a central government. A sovereign entity would not include commercial enterprises owned by the central government that are engaged in activities involving trade, commerce, or profit, which are generally conducted or performed in the private sector.

The agencies are proposing that a bank determine its specific risk-weighting factors for sovereign debt positions based on OECD Country Risk Classifications (CRCs).<sup>17</sup> The OECD’s CRCs are used for transactions covered by the OECD arrangement on export credits in order to provide a basis under the arrangement for participating countries to calculate the premium interest rate to be charged to cover the risk of non-repayment of export credits.

The agencies believe that use of CRCs in the proposal is permissible under section 939A of the Dodd-Frank Act. Section 939A is part of Subtitle C of Title IX of the Dodd-Frank Act, which, among other things, enhances regulation by the U.S. Securities and Exchange Commission (SEC) of credit rating agencies, including Nationally Recognized Statistical Rating Organizations (NRSROs) registered with the SEC, and removes references to credit ratings and NRSROs from federal statutes. In the introductory “findings” section to Subtitle C, which is entitled

“Improvements to the Regulation of Credit Ratings Agencies,” Congress characterized credit rating agencies as organizations that play a critical “gatekeeper” role in the debt markets and perform evaluative and analytical services on behalf of clients, and whose activities are fundamentally commercial in character.<sup>18</sup> Furthermore, the legislative history of section 939A focuses on the conflicts of interest of credit rating agencies in providing credit ratings to their clients, and the problem of government “sanctioning” of the credit rating agencies’ credit ratings by having them incorporated into federal regulation.

The agencies believe that section 939A was not intended to apply to assessments of creditworthiness of organizations such as the OECD. The OECD is not subject to the sorts of conflicts of interest that affected NRSROs because the OECD is not a commercial entity that produces credit assessments for fee-paying clients, nor does it provide the sort of evaluative and analytical services as credit rating agencies. Additionally, the agencies note that the use of the CRCs is limited in the proposal and that the agencies are considering additional measures that could supplement the CRCs to determine risk-weighting factors for sovereign debt positions.

*Question 2: The agencies solicit comment on the use of the CRC ratings to assign specific risk-weighting factors to sovereign debt positions.*

The CRC methodology is used by the OECD to assess country credit risk. CRCs are produced generally for the purpose of setting minimum premium rates for transactions covered by the OECD’s Export Credit Arrangement. The CRC methodology was established in

1999 and classifies countries into categories based on the application of two basic components: the country risk assessment model (CRAM), which is an econometric model that produces a quantitative assessment of country credit risk; and the qualitative assessment of the CRAM results, which integrates political risk and other risk factors not fully captured by the CRAM. The two components of the CRC methodology are combined and result in countries being classified into one of eight risk categories (0–7), with countries assigned to the 0 category having the lowest possible risk assessment and countries assigned to the 7 category having the highest.

The agencies consider CRCs to be a reasonable alternative to credit ratings and to be more granular than the current treatment based on OECD membership. The OECD regularly updates CRCs for over 150 countries. Also, CRCs are recognized by the BCBS as an alternative to credit ratings.<sup>19</sup>

However, the agencies recognize that CRCs have certain limitations. While the OECD has published a general description of the methodology for CRC determinations, the methodology is largely principles-based and does not provide details regarding the specific information and data considered to support a CRC. Also, OECD-member sovereigns that are defined to be “high-income countries” by the World Bank are assigned a CRC of zero, the most favorable classification.<sup>20</sup> As such, a CRC classification may not accurately reflect a high income OECD country’s relative risk of default. Additionally, while the OECD reviews qualitative

<sup>17</sup> Please refer to [http://www.oecd.org/document/49/0,3343,en\\_2649\\_34169\\_1901105\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/49/0,3343,en_2649_34169_1901105_1_1_1_1,00.html) for more information on the OECD country risk classification methodology.

<sup>18</sup> See Public Law 111–203, section 931.

<sup>19</sup> New Accord at paragraph 55.

<sup>20</sup> OECD, premium related conditions: Explanation of the premium rules of the arrangement on officially supported export credits (the Knaepen Package), 06, July–2004, p. 3, n5.

factors for each sovereign on a monthly basis, quantitative financial and economic information used to assign CRCs is available only annually in some cases, and payment performance is updated quarterly. The agencies are concerned that, in some cases, the CRC may misclassify risks for purposes of assessing risk-based capital requirements, particularly where sovereign debt restructuring has occurred. In such cases, the CRC appears to assess the risk associated with the sovereign's payment of the restructured debt and may not fully reflect the credit event associated with the restructuring.

To alleviate concerns about potential misclassifications, the agencies are proposing to apply a specific risk-weighting factor of 12.0 percent to sovereign debt positions where the sovereign has defaulted on any exposure during the previous five years. The proposed rule would define a default by a sovereign as noncompliance by a sovereign entity with its external debt

service obligations or the inability or unwillingness of a sovereign entity to service an existing obligation according to its terms, as evidenced by failure to make full and timely payments of principal and interest, arrearages, or restructuring. A default would include a voluntary or involuntary restructuring that results in a sovereign entity not servicing an existing obligation in accordance with the obligation's original terms.

For purposes of the proposed rule, the agencies assigned specific risk-weighting factors to CRCs in a manner consistent with the assignment of risk weights to CRCs under the Basel II standardized framework, as set forth in table 3.

TABLE 3—MAPPING OF CRC TO RISK WEIGHTS UNDER THE BASEL ACCORD

CRC classification	Risk weight (in percent)
0-1 .....	0
2 .....	20

TABLE 3—MAPPING OF CRC TO RISK WEIGHTS UNDER THE BASEL ACCORD—Continued

CRC classification	Risk weight (in percent)
3 .....	50
4 to 6 .....	100
7 .....	150
No classification assigned ..	100

Similar to the 2005 revisions, the proposed specific risk-weighting factors for sovereign debt positions would range from zero percent for those assigned a CRC of 0 or 1 to 12.0 percent for a sovereign position assigned a CRC of 7. Also similar to the 2005 revisions, the specific risk-weighting factor for certain sovereigns that are deemed to be low credit risk based on their CRC would vary depending on the remaining maturity of the position. The proposed specific risk-weighting factors for sovereign debt positions are shown in Table 4.

TABLE 4—PROPOSED SPECIFIC RISK-WEIGHTING FACTORS FOR SOVEREIGN DEBT POSITIONS

Sovereign CRC	Specific risk-weighting factor (in percent)	
0-1 .....	0.0	
2-3 .....	Residual term to final maturity 6 months or less .....	0.25
	Residual term to final maturity greater than 6 and up to and including 24 months .....	1.0
	Residual term to final maturity exceeding 24 months .....	1.6
4-6 .....	8.0	
7 .....	12.0	
No CRC .....	8.0	

As under the general risk-based capital rules, a bank may assign to a sovereign debt position a specific risk-weighting factor that is lower than the applicable specific risk-weighting factor in Table 4 if the position is denominated in the sovereign entity's currency, the bank has at least an equivalent amount of liabilities in that currency, and the sovereign entity allows banks under its jurisdiction to assign the lower specific risk-weighting factor to the same position.

The agencies have included exceptions to this general approach. For instance, sovereign debt positions that are exposures to the United States government and its agencies always would be treated as having a CRC of zero, and sovereign debt positions of sovereign entities that have no CRC generally would be assigned an 8.0 percent specific risk-weighting factor.

Alternative Market-based Approaches for Sovereign Debt Positions

In developing the proposed rule, the agencies considered a range of financial and market-based alternatives to the use of credit ratings, either as a replacement for or to supplement the use of CRCs. Two possible market-based indicators are sovereign credit default swap (CDS) spreads, or bond spreads. Both of these market-based indicators could be more "forward looking" than indicators based on historical information, and, under such an approach, banks would assign specific risk-weighting factors based on whether the CRC or the spread methodology indicated a higher capital requirement. Use of these market-based indicators along with CRCs could also improve overall accuracy in assignment of specific risk-weighting factors, especially for certain high-income OECD countries.

Credit default swap spreads for a given sovereign could be used to assign specific risk-weighting factors, with higher CDS spreads resulting in assignments of higher specific risk-weighting factors. The presumption is that CDS spreads will reflect market perception of a sovereign's default risk. To make such an approach practicable, the agencies would need to implement a methodology that mitigates concerns regarding volatility and information content of CDS spreads. For instance, the agencies could require use of five-year CDS premiums, which are the most liquid contracts traded and are generally considered the most widely-recognized benchmark in this context. To limit volatility concerns, the CDS spread could be calculated as a one-year, rolling daily average of a sovereign's CDS premium. To focus on country-specific levels of risk premiums, the agencies could subtract a designated

base rate, for example, 50 basis points, which is based on the long-term historical average of United States CDS spreads. Table 5 illustrates how CDS spreads and CRCs could be used together to assign specific risk-weighting factors. In order to have an approach that uses CDS spreads and CRCs, a position's specific risk-

weighting factor would be based on the higher of the specific risk-weighting factors required by the sovereign's CRC rating and its CDS spread from table 5. To illustrate this approach, assume a sovereign is assigned a zero CRC rating and the one year average of the five-year CDS spread of the sovereign is 150 basis points above the base rate. Since the

specific risk-weighting factor assigned to the CDS spread is higher than the specific risk-weighting factor assigned to the CRC rating, the applicable risk-weighting factor for positions that are exposures to that sovereign would be based on the CDS spread, or 4.0 percent.

TABLE 5—SPECIFIC RISK-WEIGHTING FACTORS FOR SOVEREIGN DEBT POSITIONS USING CDS SPREADS AND CRCs

Range of the one-year average of the five-year CDS spread above a 50 basis point spread	CRC	Specific risk-weighting factor (in percent) for
0–100 basis points	0–2	0.0
Greater than 100 to 250 basis points	3	4.0
Greater than 250 to 500 basis points	4–6	8.0
Greater than 500 basis points	7	12.0

Sovereign bond spreads could also be used to assign specific risk-weighting factors, with higher bond credit spreads for a given sovereign resulting in higher risk specific risk-weighting factors, similar to the methodology described above for CDS spreads. As with CDS spreads, the presumption is that sovereign bond credit spreads reflect market expectations of default risk. However, in order to use bond credit spreads, the agencies would need to address certain challenges. For example, sovereign bonds usually are denominated in the currency of the country of issuance and spreads that are calculated from sovereign bond yields in different currencies would reflect factors other than credit risk, such as the sovereign's inflation rate and its currency's exchange rate with other currencies. Therefore, it would be difficult to determine what portion of a sovereign's total bond spread reflects credit risk. As a result, it also would be difficult to compare the relative likelihood of default among sovereign debt positions.

A possible solution could be to use only bonds denominated in U.S. dollars, and perhaps one or two other major currencies as base currencies. Under such an approach, a "base" obligation with relatively low credit risk (in the case of U.S. dollar-denominated notes, a U.S. Treasury bond) would be identified and the spread between that obligation and that of bonds issued by other sovereign entities in the same currency with similar remaining maturity would be used to assign the specific risk-weighting factor. A similar process could be used for bonds denominated in euros, with the issuance of a particular sovereign entity deemed low credit risk based on a certain period of market

history providing the "base" rate to which other euro-denominated bonds of similar remaining maturity would be compared in order to determine the specific risk-weighting factor for those obligations.

Such an approach may be limited in scope as many sovereign entities either do not issue bonds in currencies other than their own, or issue very small amounts. For instance, approximately 70 countries have some U.S. dollar-denominated debt outstanding, but such issuances are usually infrequent and small in dollar volume. Issuances of euro- and yen-denominated bonds are much less frequent than those of dollar-denominated bonds. In addition, some of the problems involved in incorporating a methodology based on CDS spreads could also be relevant to a bond spread methodology.

*Question 3: How well does the proposed methodology assign specific risk-weighting factors to sovereign debt positions that are commensurate with the relative risk of such exposures? How could it be improved? What are the relative merits of the two market-based alternatives described above (using sovereign CDS spreads and bond spreads) as supplements to the CRC ratings?*

2. Exposures to Certain Supranational Entities and Multilateral Development Banks

Under the agencies' current market risk capital rules, debt positions that are exposures to certain supranational entities and multilateral development banks (MDBs) receive specific risk-weighting factors that range between 0.25 percent and 1.6 percent, depending on their remaining maturity. Under the Basel market risk framework, as revised, these positions continue to receive the

same treatment as in the agencies' current market risk capital rules.

The proposed rule defines an MDB to include the International Bank for Reconstruction and Development, the Multilateral Investment Guarantee Agency, the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the European Investment Fund, the Nordic Investment Bank, the Caribbean Development Bank, the Islamic Development Bank, the Council of Europe Development Bank, and any other multilateral lending institution or regional development bank in which the U.S. government is a shareholder or contributing member or which the bank's primary federal supervisor determines poses comparable credit risk.

Consistent with the treatment of exposures to supranational entities under the New Accord, the agencies are proposing to assign a zero percent specific risk-weighting factor to debt positions that are exposures to the Bank for International Settlements, the European Central Bank, the European Commission, and the International Monetary Fund.

Generally consistent with the Basel framework, the agencies also are proposing to apply a zero percent specific risk-weighting factor to debt positions that are exposures to MDBs, as defined in the proposed rule. This treatment is based on these MDBs' generally high-credit quality, strong shareholder support, and a shareholder structure comprised of a significant proportion of sovereign entities with strong creditworthiness.

Debt positions that are exposures to other regional development banks and multilateral lending institutions that do not meet these requirements would generally be treated as corporate debt positions and would be subject to the proposed methodology, as described below.

3. Exposures to Government Sponsored Entities

Under the current market risk capital rules, debt positions that are exposures to government sponsored entities (GSEs) <sup>21</sup> are assigned specific risk-weighting factors ranging from 0.25 percent to 1.6 percent, depending on maturity. For the purposes of this proposal, a GSE would be defined as an agency or corporation originally established or chartered by the U.S. Government to serve public purposes specified by the U.S. Congress, but whose obligations are not explicitly guaranteed by the full faith and credit of the U.S. government. In this proposal, and consistent with the treatment of these positions in the current market risk capital rules, the agencies propose to apply specific risk-weighting factors ranging from 0.25 percent to 1.6 percent

to debt positions that are exposures to GSEs based on the remaining maturity of the position. GSE equity exposures, including preferred stock, would be assigned a specific risk-weighting factor of 8.0 percent.

4. Debt Positions That Are Exposures to Depository Institutions, Foreign Banks, and Credit Unions

Under the current market risk capital rules, debt positions that are exposures to banks incorporated in OECD countries generally are assigned a specific risk-weighting factor ranging from 0.25 percent to 1.6 percent based on remaining maturity of the position. Banks that are not incorporated in an OECD country are assigned similar specific risk-weighting factors if certain conditions are met, including the presence of an investment-grade rating from a credit rating agency or assessments of comparable credit quality by the investing bank. Higher specific risk-weighting factors are assigned to positions that are rated below investment grade or deemed to be of comparable credit quality. The Basel market risk framework also makes use of

credit ratings to assign specific risk-weighting factors to these positions.

This proposal would eliminate the distinction based on OECD membership for the purpose of the market risk capital rules and instead apply specific risk-weighting factors to debt positions that are exposures to depository institutions,<sup>22</sup> foreign banks, or credit unions<sup>23</sup> based on the applicable specific risk-weighting factor of the entity's sovereign of incorporation, as shown in Table 6. For example, debt positions that are exposure to a bank incorporated in a country with a CRC of 1 would be assigned a specific risk-weighting factor ranging from 0.25 percent to 1.6 percent depending on the remaining maturity of the position. For purposes of this proposal, sovereign of incorporation means the country where an entity is incorporated, chartered, or similarly established. If an entity's sovereign of incorporation is assigned to the 8.0 percent specific risk-weighting factor because of a lack of CRC rating, then the debt position that is an exposure to that entity would also be assigned an 8.0 percent specific risk-weighting factor.

TABLE 6—SPECIFIC RISK-WEIGHTING FACTORS FOR DEPOSITORY INSTITUTION, FOREIGN BANK, AND CREDIT UNION DEBT POSITIONS

CRC of sovereign of incorporation	Specific risk-weighting factor (in percent)	
0–2 .....	Residual term to final maturity 6 months or less .....	0.25
	Residual term to maturity up to and including 24 months .....	1.0
Residual term to final maturity exceeding 24 months	1.6.	
3 .....		8.0
4–7 .....		12.0
No CRC .....		8.0

Consistent with the general risk-based capital rules, debt positions that are exposures to a depository institution or foreign bank that are includable in the regulatory capital of that entity, but that are not subject to deduction as a reciprocal holding would be assigned a specific risk-weighting factor of at least 8.0 percent.<sup>24</sup>

*Question 4: How well does the proposed methodology assign specific risk-weighting factors that are commensurate with the relative risk of*

*positions that are exposures to depository institutions, foreign banks, and credit unions?*

5. Exposures to Public Sector Entities (PSEs)

The agencies' current market risk capital rules assign specific risk-weighting factors to general obligations of states and other political subdivisions of OECD countries that range from 0.25 percent to 1.6 percent based on maturity.<sup>25</sup> Positions that are revenue

obligations of states and other political subdivisions of OECD countries are treated in the same manner if certain conditions are met. These conditions include the presence of an investment grade rating or an assessment of comparable credit quality by the bank holding the covered position. The 2005 revisions to the Basel market risk framework use credit ratings to assign specific risk-weighting factors.

The proposed rule defines a PSE as a state, local authority, or other

<sup>21</sup> These agencies include the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, the Farm Credit System, and the Federal Home Loan Bank System.

<sup>22</sup> A depository institution is defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813), and foreign bank means a foreign bank as defined in § 211.2 of the Federal Reserve Board's

Regulation K (12 CFR 211.2), other than a depository institution.

<sup>23</sup> Under this proposal, a credit union is defined as an insured credit union as defined under the Federal Credit Union Act (12 U.S.C. 1752).

<sup>24</sup> 12 CFR part 3, Appendix A, section 2(c)(6)(ii) (OCC); 12 CFR parts 208 and 225, Appendix A,

section II.B.3 (FRB); 12 CFR part 325, Appendix A, I.B.(4) (FDIC).

<sup>25</sup> Political subdivisions include a state, county, city, town or other municipal corporation, a public authority, and generally any publicly owned entity that is an instrument of a state or municipal corporation.

governmental subdivision below the level of a sovereign entity. This definition does not include commercial companies owned by a government that engage in activities involving trade, commerce, or profit, which are generally conducted or performed in the private sector. The agencies propose that the specific risk-weighting factor assigned to a debt position that is an exposure to a PSE be based on the CRC assigned to the country of incorporation of the PSE, as well as whether the position is a general obligation or a revenue obligation of the PSE. This methodology is similar to the approach under the Basel II standardized approach for credit risk, which allows a bank to assign a risk weight to PSEs based on the credit rating of the sovereign of incorporation of the PSE.

A general obligation is defined as a bond or similar obligation that is guaranteed by the full faith and credit of states or other political subdivisions of a sovereign entity. Revenue obligation is defined as a bond or similar obligation that is an obligation of a state or other political subdivision of a sovereign entity, but which the government entity is committed to repay with revenues from a specific project financed rather than with general tax funds.

For example, two debt positions with a remaining maturity exceeding 24 months that are exposures to the same PSE—one a general obligation and the other a revenue obligation—would be assigned different specific risk-weighting factors as follows: if the sovereign of incorporation has a CRC of

2, the general obligation debt position would receive a 1.6 percent specific risk-weighting factor, and the revenue obligation debt position would receive a 8.0 percent specific risk-weighting factor. If a PSE's sovereign of incorporation was assigned to the 8.0 percent specific risk-weighting factor due to a lack of a CRC, then a debt position that is an exposure to that PSE also would be assigned an 8.0 percent specific risk-weighting factor.

The specific risk-weighting factors for debt positions that are general obligations and revenue obligations of PSEs, based on the PSE's country of incorporation, are shown in Tables 7 and 8, respectively.

TABLE 7—SPECIFIC RISK-WEIGHTING FACTORS FOR GENERAL OBLIGATION DEBT POSITIONS IN PSES

Sovereign CRC rating	General obligation claims risk-weighting factor (in percent)	
0–2	Residual term to final maturity 6 months or less	0.25
	Residual term to final maturity greater than 6 and up to and including 24 months	1.0
	Residual term to final maturity exceeding 24 months	1.6
3	8.0	
4–7	12.0	
No CRC	8.0	

TABLE 8—SPECIFIC RISK-WEIGHTING FACTORS FOR REVENUE OBLIGATION COVERED POSITIONS IN PSES

Sovereign CRC rating	Revenue obligation risk-weighting factor (in percent)	
0–1	Residual term to final maturity 6 months or less	0.25
	Residual term to final maturity greater than 6 and up to and including 24 months	1.0
	Residual term to final maturity exceeding 24 months	1.6
2–3	8.0	
4–7	12.0	
No CRC	8.0	

In certain cases, the agencies have allowed a bank to use specific risk-weighting factors assigned by a foreign banking supervisor to debt positions that are exposures to PSEs in that supervisor's home country. Therefore, the agencies propose to allow a bank to assign a specific risk-weighting factor to a debt position that is an exposure to a foreign PSE according to the specific risk-weighting factor that the foreign banking supervisor assigns. In no event,

however, may the specific risk-weighting factor for such a position be lower than the lowest specific risk-weighting factor assigned to that PSE's sovereign of incorporation.

*Question 5: How well does this method of assigning specific risk-weighting factors to positions that are exposures to PSEs do so in a manner that is consistent and commensurate with the relative risk of such exposures? How could it be improved?*

6. Corporate Debt Positions  
Background

The current market risk capital rules specific risk-weighting factors for debt and securitization positions are based on the BCBS's 1996 market risk framework. Under the current rules, capital requirements are a function of the type of obligor, the credit rating of the obligor, and the remaining maturity of the exposure (see Table 9).

TABLE 9—SPECIFIC RISK—WEIGHTING FACTORS FOR COVERED CORPORATE DEBT POSITIONS UNDER THE AGENCIES’ MARKET RISK CAPITAL RULES

Category	Remaining maturity (contractual)	Specific risk-weighting factor (in percent)
Qualifying <sup>1</sup>	6 months or less	0.25
	Over 6 months to 24 months	1.00
Other <sup>2</sup>	Over 24 months	1.60
	N/A	8.00

<sup>1</sup> The “qualifying” category includes debt instruments that are: (1) Rated investment grade by at least two nationally recognized credit rating services; (2) rated investment grade by one nationally recognized credit rating agency and not rated less than investment grade by any other credit rating agency; or (3) unrated, but deemed to be of comparable investment quality by the reporting bank and the issuer has instruments listed on a recognized stock exchange, subject to supervisory review.

<sup>2</sup> The “other” category includes debt instruments that are not included in the government or qualifying categories.

Under the agencies’ general risk-based capital rules, exposures to companies, generally are assigned to the 100 percent risk weight category. A 20 percent risk weight is assigned to bank claims on, or guaranteed by, a securities firm

incorporated in an OECD country, that satisfy certain conditions.<sup>26</sup>

The 2005 revisions to the BCBS market risk framework change the standardized measurement method for calculating specific risk add-ons for debt

positions. Among the changes, the specific risk-weighting factor for debt positions rated more than two categories below investment grade increased from 8.0 percent to 12.0 percent (see Table 10).

TABLE 10—BCBS 2005 SPECIFIC RISK-WEIGHTING FACTORS FOR CORPORATE DEBT POSITIONS

External credit rating	Remaining contractual maturity	Specific risk-weighting factor (in percent)
Qualifying <sup>1</sup>	Residual term to final maturity 6 months or less	0.25
	Residual term to final maturity greater than 6 and up to and including 24 months.	1.00
	Residual term to final maturity exceeding 24 months	1.60
One category below investment grade to two categories below investment grade (for example, BB+ to B-), or equivalent based on a bank’s internal ratings.		8.00
		12.00
More than two categories below investment grade, or equivalent based on a bank’s internal ratings.		12.00
Unrated		8.00

<sup>1</sup> Under the 2005 revisions, the qualifying category includes non-sovereign debt positions that are: (i) Rated investment grade by at least two credit rating agencies specified by national authority; or (ii) rated investment grade by one credit rating agency and not rated less than investment grade by any other credit rating agency specified by national authority (subject to supervisory oversight); or (iii) subject to supervisory approval, unrated, but deemed to be of comparable investment quality by the reporting bank, and the issuer has securities listed on a recognized stock exchange.

Overview of Proposed Methodology for Corporate Debt Positions

In this NPR, the agencies propose to permit a bank to use a methodology that uses market-based information and historical accounting information (indicator-based methodology) to assign specific risk-weighting factors to corporate debt positions that are exposures to a publicly-traded entity that is not a financial institution, and to assign a specific risk-weighting factor of 8.0 percent to all other corporate debt positions excluding those that are exposures to a depository institution, foreign bank, or credit union, which are addressed above. The agencies propose to categorize financial institutions separately from other entities because of the differences in their balance sheet structures. As a simple alternative, a

bank may assign an 8.0 percent specific risk-weighting factor to all of its corporate debt positions.

The proposal would define a “corporate debt position” to mean a debt position that is an exposure to a company that is not a sovereign entity, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, a multilateral development bank, a depository institution, a foreign bank, a credit union, a PSE, a GSE, or a securitization. As discussed above, the entities scoped out of the definition of corporate debt positions would receive different treatment under the proposal.

The proposal includes the following definition of “financial institution” to distinguish between companies that are

primarily engaged in financial activities and those that are not. Under the proposal, a financial institution would be defined as:

- (1) A commodity pool as defined in section 1a(10) of the Commodity Exchange Act (7 U.S.C. 1a(10));
- (2) A private fund as defined in section 202(a) of the Investment Advisors Act of 1940 (15 U.S.C. 80–b–2(a)); except for small business investment companies, as defined in section 102 of the Small Business Investment Act of 1958 (15 U.S.C. 662), or a private fund designed primarily to promote the public welfare, of the type permitted under section 24 (Eleventh) of the National Bank Act (12 U.S.C. 24 (Eleventh)) and 12 CFR part 24;
- (3) An employee benefit plan as defined in paragraphs (3) and (32) of

<sup>26</sup> See 12 CFR part 3, appendix A, section 3(2)(xiii) (OCC); 12 CFR parts 208 and 225,

appendix A, section III.C.2 (Board), 12 CFR part

325, appendix A, section ILC, Category 2–20 Percent Risk Weight (FDIC).

section 3 of the Employee Retirement Income and Security Act of 1974 (29 U.S.C. 1002);

(4) A bank holding company, depository institution, foreign bank, credit union, insurance company, or a securities firm, other than an entity selected as a Community Development Financial Institution (CDFI) under 12 U.S.C. 4701 *et seq.* and 12 CFR part 1805;

(5) Any other company predominantly engaged in activities that are (i) in the business of banking under section 24 (Seventh) of the National Bank Act (12 U.S.C. 24), or (ii) in activities that are financial in nature under section 4(k) of the Bank Holding Company of 1956 (12 U.S.C. 1843(k)) as of the date this subpart becomes effective (collectively, “financial activities”); provided that, if the company is not an affiliate of the bank calculating its capital requirements under the proposed rule, then the bank may exclude activities set forth on Schedule A when determining whether the company is predominantly engaged in financial activities.

(6) Any non-U.S. entity that would be covered by any of paragraphs (1) through (5) if such entity was organized in the United States; or

(7) Any other company that an agency may determine is a financial institution based on the nature and scope of its activities.

(8) For the purposes of the proposed rule, a company would be “predominantly engaged” in financial activities, if:

(i) 85 percent or more of the total consolidated annual gross revenues (as determined in accordance with applicable accounting standards) of the company in either of the two most recent calendar years were derived, directly or indirectly, by the company on a consolidated basis from financial activities; or

(ii) 85 percent or more of the company’s consolidated total assets (as determined in accordance with applicable accounting standards) as of the end of either of the two most recent

calendar years were related to financial activities.

For the purpose of determining whether a company is predominantly engaged in financial activities under the proposed definition, the agencies have determined that certain financial activities may be excluded for determination regarding companies that are not affiliates of the bank. These activities are listed in Schedule A in the NPR. For purposes of the definition of financial institution, the agencies propose to define affiliate with respect to a bank to mean any company that controls, is controlled by, or is under common control with, the bank.

*Question 6: The agencies seek comment on the proposed definition of “financial institution.” The agencies have sought to achieve consistency in the definition of financial institution with similar definitions proposed for other regulations.<sup>27</sup> In particular, the agencies have incorporated the standard for “predominantly engaged” in financial activities similar to the standard from the Board’s proposed rule to define “predominantly engaged in financial activities” for purposes of Title I of the Dodd-Frank Act.<sup>28</sup> The agencies seek comment on the appropriateness of this standard for purposes of the proposed rule and whether a different threshold, such as greater than 50 percent, would be more appropriate. Responses should provide detailed explanations.*

**Methodology for Positions That Are Exposures to Publicly-Traded, Non-Financial Corporate Entities**

To use the proposed indicator-based methodology, a bank must calculate the following: (1) Leverage, measured by the ratio of total liabilities (DEBT) to the market value of assets (A); (2) cash flow, measured as the ratio of earnings before interest expense, taxes, depreciation and amortization (EBITDA) to a market value of assets; and (3) monthly stock return volatility (VOL). In order to assign a corporate debt position a specific risk-weighting factor using the indicator-based methodology, a bank

would be required to use publicly available financial data to calculate a value for each of the three indicators. Separate calculations would be made for each quarterly regulatory financial report. The calculation of debt would be based on liabilities reported as of the end of the most recent calendar quarter. Assets would be measured as the sum of the product of the number of outstanding shares as of the end of the most recent calendar quarter multiplied by the entity’s stock price on the last trading day of the most recent calendar quarter plus the measure of liabilities reported as of the end of the most recent calendar quarter. To calculate EBITDA for the three-indicator methodology, a bank would use EBITDA for the four most recent calendar quarters. The EBITDA-to-assets ratio would be calculated by dividing an entity’s cumulative EBITDA over the previous four quarters by its equity market value plus total liabilities as reported as of the end of the most recent quarter. So, for example, when measuring EBITDA on March 31, 2012, the bank likely would use EBITDA for the period from January 1, 2011, to December 31, 2011. Stock return volatility would be measured as the standard deviation of the corporate obligor’s monthly stock return as of the last trading day of each month over the immediate preceding 12 months. So, for example, stock return volatility measured as of March 31, 2012, would be based on the entity’s stock returns calculated using prices as of the last trading day of the months of March 2011 to March 2012, adjusted for stock splits.

After calculating the three indicators, a bank would assign the debt position that is an exposure to a publicly traded, non-financial institution to a specific risk-weighting factor using table 11. Similar to the current market risk capital rules and the 2005 revisions, certain high-credit-quality debt positions would be assigned a specific risk-weighting factor based on the residual maturity of the debt as shown in tables 11 and 11A.

**TABLE 11—SPECIFIC RISK-WEIGHTING FACTORS FOR NON-FINANCIAL PUBLICLY-TRADED CORPORATE DEBT POSITIONS**

EBITDA-to-assets ratio	Stock return volatility measure	Specific risk-weighting factor (in percent)		
		Debt-to-assets ratio less than 0.2	Debt-to-assets ratio between 0.2 and 0.5	Debt-to-assets ratio greater than 0.5
Greater than zero .....	less than 0.1 .....	(1)	8.0	8.0
	between 0.1 and 0.15 .....	8.0	8.0	8.0

<sup>27</sup> See the definition of “financial end user” in the proposed rule to implement provisions of the Dodd-Frank Act regarding margin and capital

requirements for certain swap entities. 76 FR 27564 (May 11, 2011).

<sup>28</sup> See 76 FR 7731 (February 11, 2011).

TABLE 11—SPECIFIC RISK-WEIGHTING FACTORS FOR NON-FINANCIAL PUBLICLY-TRADED CORPORATE DEBT POSITIONS—Continued

EBITDA-to-assets ratio	Stock return volatility measure	Specific risk-weighting factor (in percent)		
		Debt-to-assets ratio less than 0.2	Debt-to-assets ratio between 0.2 and 0.5	Debt-to-assets ratio greater than 0.5
Less than zero .....	greater than 0.15 .....	8.0	8.0	12.0
	less than 0.1 .....	8.0	8.0	8.0
	between 0.1 and 0.15 .....	8.0	8.0	12.0
	greater than 0.15 .....	12.0	12.0	12.0

<sup>1</sup> See Table 11A.

TABLE 11A—SPECIFIC RISK-WEIGHTING FACTORS NON-FINANCIAL PUBLICLY TRADED COMPANY DEBT POSITIONS

Remaining contractual maturity	Specific risk-weighting factor (in percent)
Residual term to final maturity 6 months or less .....	0.25
Residual term to final maturity greater than 6 months and up to and including 24 months .....	1.0
Residual term to final maturity exceeding 24 months .....	1.6

These three indicators represent market-based information and historical accounting data found in both industry practice and academic literature for estimating the likelihood of default. In calibrating specific risk-weighting factors using these three indicators, the agencies tried to balance the trade-offs between enhanced risk sensitivity and relative simplicity and ease of use. The three indicators chosen were found to yield relatively comparable results in terms of credit risk differentiation to alternative approaches the agencies considered that incorporate more indicators, including the Altman Z Score approach.<sup>29</sup> The agencies note that because the three-indicator methodology uses point in time financial information, results using the three indicator methodology could be cyclical.

Because the universe of public companies is significantly greater than the universe of entities that have issued public debt or that themselves are rated by the credit rating agencies, the three indicators are expected to cover more firms than an approach that relies on credit ratings. The agencies propose to permit banks to use the three indicator-methodology only for public-traded companies because private companies do not have the market data which is a critical input for this methodology.

The agencies are proposing that the three measures would be used to separate debt positions that are exposures to public companies that are

not financial institutions into three risk buckets that roughly approximate credit ratings of AAA to A, BBB to BB, and below BB. The limited granularity proposed under this methodology is intended to address limitations in the ability of the methodology to distinguish among high investment grade ratings and possible misspecification of risks between investment grade and non-investment grade ratings of “BBB” and “BB.”

*Question 7: What operational challenges, if any, would banks face in implementing the three-indicator methodology?*

*Question 8: How well does this methodology capture credit risk for purposes of assigning risk-based capital requirements for covered debt positions of publicly-traded companies that are not financial institutions? How could it be improved? Financial institution debt positions*

The agencies evaluated a number of alternatives to credit ratings for assigning specific risk-weighting factors to debt positions that are exposures to financial institutions. These alternatives include a multi-indicator methodology similar to the methodology proposed for public companies that are not financial institutions, a bond credit spread methodology described further below, and a methodology based on a notice of proposed rulemaking<sup>30</sup> and related guidance<sup>31</sup> issued by the OCC on November 29, 2011 (collectively, OCC NPR), to revise the definition of

“investment grade” as it is used in the OCC’s investment securities regulations.

Each of these alternatives was viewed as either having significant drawbacks or as not being sufficiently developed to propose them within this NPR. In evaluating whether to propose a multi-indicator methodology to distinguish risk for financial institutions, the agencies note that many financial ratios (such as debt-to-equity) vary significantly among financial industry sub-sectors, such as insurance companies, brokerage firms, and finance companies. Therefore, a ratio-based methodology for all financial institutions might not be feasible for comparing relative risk.

Given the concerns above, the agencies are proposing that all corporate debt positions issued by financial institutions be assigned a specific risk-weighting factor of 8.0 percent. The agencies intend to continue working to develop and evaluate alternative methodologies to the use of credit ratings for financial institution debt positions.

**Alternative Approach—Bond Spreads**

The agencies considered using bond spreads as an alternative to using credit ratings for assigning capital requirements to both financial and non-financial corporate debt positions. Similar to the three-indicator methodology, an approach that uses bond credit spreads would be market-based and forward-looking. Unlike the three-indicator approach, however, a bond spread approach could be particularly useful for assigning specific risk-weighting factors to financial institutions since, as noted earlier, many

<sup>29</sup> The Altman Z Score and subsequently developed variants use multiple corporate income and balance sheet values, including market value of equity, to predict default probability for a specific corporation.

<sup>30</sup> 76 FR 73526 (Nov. 29, 2011).

<sup>31</sup> 76 FR 73777 (Nov. 29, 2011).

financial ratios (such as debt-to-equity) vary significantly between financial industry sub-sectors, and therefore are not necessarily useful for comparing relative risk. However, because bond markets can sometimes misprice risk and reflect factors other than credit risk, the specific risk-weighting factors determined by this approach may not always be reliable. Additionally, because bond spreads can vary a great deal over short time periods, this approach may introduce undue

volatility into the risk-based capital requirements.

To implement a bond spread-based approach, the agencies could assign corporate debt positions to the same general categories of “high risk,” “medium risk,” or “low risk,” depending on whether the spread on the particular position is priced above or below certain market-based thresholds. Specifically, one could compare the one-year average of the spreads of a financial institution’s closest to five-year, senior unsecured bond, to the one-

year averages of two credit default swap indices, such as the five year CDX.NA.IG.FIN index<sup>32</sup> and the five-year CDX.NA.HY.B index.<sup>33</sup> This methodology could mitigate some of the concerns mentioned above, by explicitly evaluating risk on a *relative* basis and smoothing volatility by using one-year averages.

Specific risk-weighting factors could then be assigned to corporate debt positions that are exposures to public companies that are financial institutions as shown in Table 12:

TABLE 12—SPECIFIC RISK-WEIGHTING FACTORS USING CORPORATE BOND SPREADS

	Risk characterization	Possible specific risk-weighting factor (in percent)
average spread < CDX.NA.IG.FIN .....	“low risk” .....	4.0
CDX.NA.IG.FIN ≤ average spread < CDX.NA.HY.B .....	“medium risk” .....	8.0
average spread ≥ CDX.NA.HY.B .....	“high risk” .....	12.0

Specific risk-weighting factors could be assigned to corporate debt positions that are exposures to public companies

that are not financial institutions as follows:

TABLE 12A—SPECIFIC RISK-WEIGHTING FACTORS USING CORPORATE BOND SPREADS

	Risk characterization	Possible specific risk weight (in percent)
average spread < CDX.NA.IG <sup>34</sup> .....	“low risk” .....	4.0
CDX.IG ≤ average spread < CDX.NA.HY.B .....	“medium risk” .....	8.0
average spread ≥ CDX.NA.HY.B .....	“high risk” .....	12.0

The agencies believe that the “low risk” characterization would roughly correspond to a AAA–A rating, “medium risk” would roughly correspond to a BBB–BB rating, and “high risk” would correspond to a B rating or below, respectively.

*Question 9: How does this market-based alternative to credit ratings compare to the proposed approaches regarding operational feasibility and reliability in assessing risk and an appropriate amount of capital?*

*Question 10: For what types of positions would the bond spread approach be most appropriate, and for what types of positions would it not be appropriate? Are there measures of market liquidity or other factors that the agencies should consider in evaluating the applicability of a credit spread approach?*

*Alternative Approach—Distinction Based on Proposed Revised “Investment Grade” Definition for National Banks*

The agencies also are considering whether to permit banks to determine a specific risk-weighting factor for corporate debt positions based on whether the position is “investment grade,” as that term is defined in the OCC’s regulations at 12 CFR 1.2(d). Under such an approach, an investment grade exposure might be assigned a risk-weighting factor of 6.0 percent and a non-investment grade exposure might be assigned a risk-weighting factor of 12.0 percent.

The OCC’s investment securities regulations generally require a bank to determine whether or not a security is “investment grade” in order to determine whether purchasing the security is permissible. The OCC’s

investment securities regulations at 12 CFR part 1 use credit ratings as a factor for determining the credit quality, marketability, and appropriate concentration levels of investment securities purchased and held by national banks. Under the OCC rules, an investment security must not be “predominantly speculative in nature.” The OCC rules provide that an obligation is not “predominantly speculative in nature” if it is rated investment grade or, if unrated, it is the credit equivalent of investment grade. “Investment grade,” in turn, is defined as a security rated in one of the four highest rating categories by two or more national recognized statistical rating organization (NRSROs)—or one NRSRO

<sup>32</sup> The Markit CDX North American Investment Grade Financial index is a sub index of the Markit CDX North American Investment Grade index. The number of index constituents varies based upon the number of financial constituents in the parent index.

<sup>33</sup> The Markit CDX North American High Yield B index is a sub index of the Markit CDX North American High Yield index. The number of index constituents varies based upon the number of B rated constituents in the parent index.

<sup>34</sup> The Markit CDX North American Investment Grade index is composed of one hundred twenty

five (125) investment grade entities domiciled in North America, distributed among five (5) sub-sectors. Each reference entity is given approximately equal weighting, and index constituents are periodically updated using a rules-based approach accounting for liquidity, outstanding debt and rating.

if the security has been rated by only one NRSRO.<sup>35</sup>

Under the OCC's recently proposed revisions to its investment securities regulations, a security would be "investment grade" if the issuer of the security has an adequate capacity to meet financial commitments under the security for the projected life of the security.<sup>36</sup> The "adequate capacity to meet financial commitments" standard would replace language in 12 CFR 1.2 which currently references NRSRO credit ratings. To meet this new standard, national banks would have to determine that the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected.

When determining whether a particular issuer has an adequate capacity to meet financial commitments under a security for the projected life of the security, the OCC would expect national banks to consider a number of factors, to the extent appropriate. These may include consideration of internal analyses, third-party research and analytics including external credit ratings, internal risk ratings, default statistics, and other sources of information as appropriate for the particular security. Additionally, when purchasing a corporate debt security, a bank would be expected to be able to confirm that the credit spread to U.S. Treasuries is consistent with bonds of

similar credit quality; confirm that the risk of default is low and consistent with bonds of similar credit quality; and show that it understands local demographics and economics relevant to the performance of the obligor.

While external credit ratings and assessments would remain a valuable source of information and provide national banks with a standardized credit risk indicator, banks would have to supplement the credit ratings with due diligence processes and analyses that are appropriate for the bank's risk profile and for the amount and complexity of the debt instrument. Therefore, it would be possible that a security rated in the top four rating categories by a credit rating agency may not satisfy the proposed revised investment grade standard.

The agencies believe such an approach would be consistent with current practices and therefore relatively simple for banks to implement. Additionally, banks would be able to apply it to corporate debt securities issued by both financial and non-financial institutions. However, this approach has limited granularity.

*Question 11: What are the pros and cons of a more simple approach, which distinguishes only among investment grade and non-investment grade corporate debt positions relative to the more granular three-indicator methodology? What are the pros and cons of offering the investment grade/*

*non-investment grade (under the OCC's proposed revisions to 12 CFR part 1) approach as an alternative for banks that do not use the three-indicator approach?*

7. Securitization Positions

Under the current market risk capital rules, if a bank does not model specific risk, it must calculate a specific risk capital add-on for each securitization position subject to the rule using a standardized method. Under the standardized method, a bank must multiply the absolute value of the current market value of each net long and net short position in a securitization position by the appropriate specific risk-weighting factor specified in the rule. These specific risk-weighting factors range from zero to 8.0 percent and are based on the credit rating and remaining contractual maturity of the position. In addition, banks must apply the highest specific risk-weighting factor (8.0 percent) to unrated securitization positions.

Under the 2009 revisions and the January 2011 NPR, a bank is no longer permitted to model specific risk for securitization positions, including re-securitization positions, with the exception of certain correlation trading positions. Instead, the bank must use the specific risk-weighting factors based on credit ratings, as shown in Tables 13 and 14 below.

TABLE 13—LONG-TERM CREDIT RATING SPECIFIC RISK-WEIGHTING FACTORS FOR SECURITIZATION POSITIONS IN THE BASEL MARKET RISK FRAMEWORK

Illustrative external rating description	Example	Securitization exposure (that is not a re-securitization exposure) specific risk-weighting factor (in percent)	Re-securitization exposure specific risk-weighting factor (in percent)
Highest investment grade rating .....	AAA	1.60	3.20
Second-highest investment grade rating .....	AA	1.60	3.20
Third-highest investment grade rating .....	A	4.00	8.00
Lowest investment grade rating .....	BBB	8.00	18.00
One category below investment grade .....	BB	28.00	52.00
Two categories below investment grade .....	B	100.00	100.00
Three categories or more below investment grade .....	CCC	100.00	100.00

TABLE 14—SHORT-TERM CREDIT RATING SPECIFIC RISK-WEIGHTING FACTORS FOR SECURITIZATION POSITIONS IN THE BASEL MARKET RISK FRAMEWORK

Illustrative external rating description	Example	Securitization exposure (that is not a re-securitization exposure) specific risk-weighting factor (in percent)	Re-securitization exposure specific risk-weighting factor (in percent)
Highest investment grade rating .....	A-1/P-1	1.60	3.20
Second-highest investment grade rating .....	A-2/P-2	4.00	8.00

<sup>35</sup> An NRSRO is a credit rating agency registered with the U.S. Securities and Exchange Commission.

<sup>36</sup> 76 FR 73526 (Nov. 29, 2011).

TABLE 14—SHORT-TERM CREDIT RATING SPECIFIC RISK-WEIGHTING FACTORS FOR SECURITIZATION POSITIONS IN THE BASEL MARKET RISK FRAMEWORK—Continued

Illustrative external rating description	Example	Securitization exposure (that is not a re-securitization exposure) specific risk-weighting factor (in percent)	Re-securitization exposure specific risk-weighting factor (in percent)
Third-highest investment grade rating .....	A-3/P-3	8.00	18.00
All other ratings .....	N/A	100.00	100.00

In this proposal, a securitization generally means a transaction in which (1) all or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties; (2) the credit risk associated with the underlying exposures has been separated into at least two tranches that reflect different levels of seniority; (3) performance of the securitization position depends upon the performance of the underlying exposures; (4) all or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities); (5) for non-synthetic securitizations, the underlying exposures are not owned by an operating company; (6) the underlying exposures are not owned by a small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682); and (7) the underlying exposures are not owned by a firm, an investment in which qualifies as a community development investment under 12 U.S.C. 24 (Eleventh). A re-securitization means a securitization in which one or more of the underlying exposures is a securitization position. Securitization position means a covered position that is an on-balance sheet or off-balance sheet credit exposure (including credit-enhancing representations and warranties) that arises from a securitization (including a re-securitization); or an exposure that directly or indirectly references a securitization exposure. A re-securitization position means a covered position that is an on- or off-balance sheet exposure to a re-securitization; or an exposure that directly or indirectly references a re-securitization exposure.

Under the proposed rule, the agencies have developed a simplified version of the Basel II advanced approaches supervisory formula approach (SFA) to assign specific risk-weighting factors to securitization positions including re-securitization positions. In this

proposal, the simplified version is referred to as the simplified supervisory formula approach (SSFA). If a bank cannot, or chooses not to, use the SSFA, a securitization position would be subject to a specific risk-weighting factor of 100 percent, which is roughly the equivalent of a 1,250 percent risk weight.

Similar to the SFA, the SSFA is based on the capital requirements that would be applied to all exposures underlying a securitization.<sup>37</sup> A bank would need several inputs to calculate the SSFA. The first input is the weighted-average capital requirement under the general risk-based capital rules that would be assigned to the underlying exposures, if those exposures were held directly by the bank. The second and third inputs indicate the position's level of subordination and relative size within the securitization. The fourth input is the level of losses actually experienced on the underlying exposures.

The SSFA is designed to apply relatively higher capital requirements to the more risky junior tranches of a securitization that are the first to absorb losses and relatively lower requirements to the most senior positions. The SSFA applies a 100 percent specific risk-weighting factor (roughly equivalent to a 1,250 percent risk weight) to securitization positions that absorb losses up to the amount of capital that would be required for the underlying exposures under the agencies' general risk-based capital rules had those exposures been held directly by a bank. For example, assume a securitization position that is backed by a \$100 pool of auto loans is subject to a 100 percent risk weight under the agencies' general risk-based capital rules. Application of a 100 percent risk weight to the \$100 pool of loans would result in a total risk-based capital requirement of \$8. Therefore, under the SSFA,

<sup>37</sup> When using the SFA, a bank must meet minimum requirements under the Basel internal ratings-based approach to estimate probability of default and loss given default for the underlying exposures. Under the U.S. risk-based capital rules, the SFA is available only to banks that have been approved to use the advanced approaches.

securitization positions that would absorb up to the first \$8 of loss in the securitization would be assigned a specific risk-weighting factor of 100 percent. For the remaining securitization tranches in this example that absorb losses beyond the first \$8, the SSFA would apply capital requirements that would decrease as the seniority of the positions increases, subject to the supervisory floor, as described below.

Apart from the floor and other supervisory adjustments, the SSFA attempts to be as consistent as possible with the general risk-based capital rules that would apply if the underlying exposures were held directly by a bank. At the inception of a securitization, the SSFA would require more capital on a transaction-wide basis than would be required if the pool of assets had not been securitized. That is, if the bank held every tranche of a securitization, its overall capital charge would be greater than if the bank held the underlying assets in portfolios. The agencies believe that this effect would reduce the ability of banks to engage in regulatory capital arbitrage through the use of securitization. However, as discussed in more detail below, the agencies are seeking comment on whether it would be appropriate to make other adjustments to the SSFA that would either increase or decrease the overall capital requirements that would be produced using the SSFA.

Under the proposed rule, the SSFA specific risk-weighting factor for a position depends on the following inputs:

(i)  $K_G$  is the weighted-average capital requirement of the underlying exposures calculated using the agencies' general risk-based capital rules.

(ii) Parameter A is the attachment point of the position. This represents the threshold at which credit losses would first be allocated to the position. This input is the ratio, expressed as a decimal value between zero and one, of the dollar amount of the securitization positions that are subordinated to the position to the dollar amount of the entire pool of underlying assets.

(iii) Parameter D is the detachment point of the position. This represents the threshold at which credit losses allocated to the position would result in a total loss to the investor in the position. This input, which is a decimal value between zero and one, equals the value of Parameter A plus the ratio of (1) the dollar amount of the positions and all *pari passu* positions to (2) the dollar amount of the underlying exposures.

(iv) A supervisory calibration parameter, p. For securitization positions that are not re-securitization positions, this input is 0.5; for re-securitization positions, it is 1.5.

(v) Cumulative losses on the underlying pool of exposures, which affects the level of the specific risk-weighting factor floor, as discussed below.

A bank may use the SSFA to determine its specific risk-weighting factor for a securitization position only if it has information to assign each of the parameters for the position. In particular, if the bank does not know  $K_G$  for a position because it lacks the necessary information on the underlying exposures, the bank may not use the SSFA to determine its specific risk-weighting factor. Rather, the bank must apply a specific risk-weighting factor of 100 percent. The agencies believe that for most securitizations, the inputs to the SSFA are readily available from prospectuses for newly-issued securitizations and from servicer reports for existing securitizations.

The SSFA specific risk-weighting factor for the portion of a securitization position not subject to the 100 percent specific risk-weighting factor applied to the junior-most portion of the transaction is:

**SSFA Formula**

$$K_{SSFA} = \frac{e^{a \cdot u} - e^{a \cdot l}}{a(u - l)}$$

Where,

$$a = - \frac{1}{p \cdot K_G},$$

$$u = D - K_G$$

$$l = A - K_G$$

$$e = 2.71828$$

(the base of the natural logarithms) is equal to the greater of:

- (i)  $K_{SSFA}$  multiplied by 100 and expressed as a percent; or
- (ii) The supervisory minimum specific risk-weighting factor assigned to the tranche based on cumulative losses (see Table 15)

The agencies are proposing to apply a specific risk-weight factor floor that will increase as cumulative losses on the pool increase over time (see Table 15). This feature will enhance the risk sensitivity of the capital requirements for securitization positions by increasing the capital requirements for securitization exposures—particularly more senior tranches—as underlying pool quality exhibits credit deterioration. Under the agencies' current market risk capital rules, many senior securitization positions require limited amounts of capital, even if their external ratings are substantially downgraded. During the crisis, a number of highly rated senior securitization positions were subject to significant downgrades and suffered substantial losses. As indicated in the January 2011 NPR, the agencies are seeking to ensure that sufficient capital is held against such positions and that

the amount of required capital is consistent with international agreements.

**TABLE 15—SUPERVISORY MINIMUM SPECIFIC RISK-WEIGHTING FACTOR FLOORS FOR SECURITIZATION EXPOSURES**

Cumulative losses of principal on originally issued securities as a percent of $K_G$ at origination		Specific risk-weighting factor (in percent)
Greater than:	Less than or equal to:	
0	50	1.6
50	100	8.0
100	150	52.0
150	n/a	100.0

For example, if cumulative losses on a securitized residential mortgage pool, where the general risk-based capital requirement is 4 percent, rose to 3 percent (or 75 percent of the capital requirement on the underlying asset pool), the minimum specific risk-weighting factor would increase from 1.6 percent to 8.0 percent in accordance with table 15 above.

**SSFA Example**

To illustrate the specific risk-weighting factors produced by the SSFA, assume a hypothetical residential mortgage-backed securitization composed of four tranches: a senior-most tranche (S) and three junior tranches (M1, M2, and M3). Further assume that  $K_G$  is 4.0 percent (based on the 50 percent risk weight applied to prudently underwritten residential mortgages in the agencies' general risk-based capital framework). Table 16 shows the original balance, attachment point, detachment point, and SSFA specific risk-weighting factor for each tranche.

**TABLE 16—EXAMPLE OF A HYPOTHETICAL RESIDENTIAL MORTGAGE-BACKED SECURITIZATION**

Tranche	Current balance (\$)	Attachment point (in percent)	Detachment point (in percent)	SSFA specific risk-weighting factor (in percent)
S .....	1,988,831,790	10.00	100.00	1.6
M1 .....	88,392,524	6.00	10.00	15.9
M2 .....	44,196,262	4.00	6.00	63.2
M3 .....	88,392,524	0.00	4.00	100

To illustrate the effect of the SSFA on the specific risk-weighting factor as cumulative losses on the underlying exposures rise from a significant deterioration in credit quality, the following chart assumes that cumulative losses are equal to \$121,539,720 (or 5.50

percent of the original balance). This represents cumulative losses that are approximately 137 percent of the original amount of capital that would be required to be held against the underlying exposures at origination as they were held directly by a bank ( $K_G$ ).

As such, the minimum supervisory specific risk-weighting factor increases from 1.6 percent to 52 percent. Tranche M3 is reduced to \$0 as it absorbs losses in the amount of its principal balance. Similarly, tranche M2 reduces in size from \$44,196,262 to \$11,049,066 as it

absorbs the losses not absorbed by tranche M3.

Tranche	Current balance (\$)	Attachment point (in percent)	Detachment point (in percent)	SSFA specific risk-weighting factor (in percent)
S .....	1,988,831,790	4.76%	100.00	52
M1 .....	88,392,524	0.53	4.76	97
M2 .....	11,049,066	0.00	0.53	100
M3 .....	.....	0.00	0.00	.....

#### Specific Risk-Weighting Factors for Non-Modeled Securitization Positions and Modeled Correlation Trading Positions

The proposed rule specifies the following treatment for the determination of the total specific risk add-on for a portfolio of modeled correlation trading positions and for non-modeled securitization positions. For purposes of a bank calculating its comprehensive risk measure with respect to either the surcharge or floor calculation for a portfolio of correlation trading positions modeled under section 9 of the January 2011 NPR, the total specific risk add-on would be the greater of: (1) The sum of the bank's specific risk add-ons for each net long correlation trading position calculated using the standardized measurement method; or (2) the sum of the bank's specific risk add-ons for each net short correlation trading position calculated using the standardized measurement method.

For a bank's securitization positions that are not correlation trading positions and for securitization positions that are correlation trading positions not modeled under section 9 of the January 2011 NPR, the total specific risk add-on would be the greater of: (1) The sum of the bank's specific risk add-ons for each net long securitization position calculated using the standardized measurement method; or (2) the sum of the bank's specific risk add-ons for each net short securitization position calculated using the standardized measurement method.

This treatment is consistent with the BCBS's revisions to the market risk framework. With respect to securitization positions that are not correlation trading positions, the BCBS's June 2010 revisions provided a transitional period for this treatment. Thus, the agencies anticipate potential reconsideration of this provision at a future date.

#### Alternative Calibrations

Under certain circumstances, the SSFA may produce a specific risk-weighting factor for a securitization

position that exceeds the specific risk-weighting factor that would otherwise be generated by the Basel market risk framework's ratings-based approach. For example, certain junior and mezzanine tranches of residential mortgage, credit card, or automobile loan securitization positions may attract a 100 percent specific risk-weighting factor under the SSFA while, depending upon the tranches' credit ratings, the ratings-based approach could assign significantly lower capital requirements. This occurs because the SSFA relies on: (1) The risk weight that would be assigned to the underlying exposures under the general risk-based capital rules, were the exposures held on the bank's balance sheet; and, (2) the particular position's attachment and detachment points. The SSFA does not take into consideration many forms of credit enhancements, such as excess spread, that may be recognized by credit rating agencies when assigning credit ratings. As such, the SSFA will result in a 100 percent specific risk-weighting factor for all securitization positions that detach at or below  $K_G$ .

To better align the specific risk-weighting factors generated by the SSFA with those from the ratings-based approach, the agencies could alter certain parameters in the SSFA. For example, for an automobile securitization, the risk weight generally applicable to the underlying exposures is 100 percent. Therefore, the SSFA assigns a 100 percent specific risk-weighting factor to securitization positions that detach at or below an 8 percent  $K_G$ . However, many automobile securitizations include credit enhancements, such as overcollateralization, and excess spread that would not be recognized under the SSFA.

To adjust for the lack of recognition of certain forms of credit enhancement, the agencies could introduce a scaling factor to adjust the SSFA based on the type or quality of assets underlying a securitization. The introduction of such a scaling factor could reduce the overall impact of the 100 percent specific risk-weighting factors for securitization

positions that detach at or below an 8 percent  $K_G$ . For example, the agencies could scale  $K_G$  by 50 percent so that the 100 percent specific risk-weighting factor for such positions would be applied to the first 4 percent ( $0.5 * 8$  percent = 4 percent) of the securitization structure rather than the 8 percent value in the example above.

More generally, establishing and adjusting the scaling factor would affect the overall amount of capital required by the SSFA on a transaction-wide basis across the tranches of a securitization. Lower values would correspond to a lower aggregate capital requirement and higher values to a higher aggregate requirement.

*Question 12: Is the SSFA function appropriately calibrated and would it be a feasible and appropriate methodology for assigning specific risk add-ons for securitization positions? Why or why not? Are the minimum risk-weighting factors appropriate and appropriately calibrated? Why or why not? Please provide detailed responses and supporting data wherever possible.*

*Question 13: What are the benefits and drawbacks to using a scaling factor to better align the minimum capital requirements under the SSFA with those generated by the ratings-based approach? What other adjustments could the agencies consider to better recognize credit enhancements and align the minimum capital requirements? Please provide specific details on the mechanics of, and rationale for, any suggested methodology and the position types to which it should apply. How should an adjustment, such as a scaling factor, be implemented? For example, should it take into account the type of credit enhancement, asset class, loss experience, prudential requirements, or other criteria, and if so how and why?*

#### Alternative Using a Concentration Ratio

The 2009 revisions incorporate several alternatives for assigning specific risk-weighting factors to unrated securitization positions. For example, for securitization positions that do not meet the requirements for

the Basel market risk framework's ratings-based approach, a bank may set the specific risk add-on for the securitization position equal to the absolute value of the market value of the effective notional amount of each net long or net short securitization position in the portfolio multiplied by 8 percent of the dollar-weighted average risk weight applicable to the underlying exposures and by a concentration ratio. The concentration ratio equals the sum of the notional amounts of all tranches in the securitization divided by the sum of the notional amounts of the tranches junior to or *pari passu* with the tranche in which the position is held, including the amount of that tranche itself. If the concentration ratio is 12.5 or higher, the bank would have to apply a specific risk-weighting factor of 100 percent to the securitization position.

The agencies are considering whether to use the concentration ratio in place of, or as a complement to, the SSFA. Like the SSFA, the concentration ratio relies on the calculation of the dollar-weighted average risk weight applicable to the underlying exposures in a

securitization position. As such, the agencies believe that the specific risk-weighting factor for securitization positions could be easily calculated using the concentration ratio.

*Question 14: What are the pros and cons of incorporating the concentration ratio into the market risk capital rules as a replacement or alternative to the SSFA?*

*Question 15: In what instances and for what types of securitization positions should the concentration ratio be used? For what types of securitization positions does the concentration ratio produce a specific risk-weighting factor that is better aligned with the risk inherent in the position than the SSFA?*

**Alternative Using a Credit Spread Approach**

Another alternative for determining the specific risk-weighting factor for a securitization could include the use of market data. Such a methodology could set and adjust the specific risk-weighting factor of a securitization position based on the spread between the rate of the position and the rate on

a U.S. Treasury obligation of similar maturity and the movements of an index of securities. This methodology would be designed to adjust specific risk-weighting factors based on changes in the risk characteristics of the individual securitization position relative to changes in the broader market. This methodology would recognize that when assessing the riskiness of a position relative to a benchmark, a change in the spread of a securitization position should be interpreted differently when comparable market spreads remain stable or when they exhibit volatility.

A credit spread approach could be based on a scoring model driven by three variables: (1) The spread of the securitization position over U.S. Treasuries of comparable maturity; (2) the spread of a high-yield index of corporate exposures (e.g., CDX.HY.B<sup>38</sup>), which captures business cycle conditions; and (3) the maturity of the securitization. The methodology could assign a score on the basis of the following formula:

$$S_i = 3 + 7.07 \cdot sp - 3.03 \cdot sp_B - 0.57 \cdot (sp - B) - 0.63 \cdot mat$$

The variables *sp*, *sp<sub>B</sub>*, and *mat* are<sup>39</sup>:

(1) The natural logarithm of the quarterly moving average of the securitization spread over U.S. Treasuries with comparable maturity,<sup>39</sup> (2) the natural logarithm of the median spread on securities included in the CDX.HY.B index over the prior five business days, and (3) the natural logarithm of the maturity of the securitization exposure, expressed in fractions of a year. The specific risk-weighting factor would be assigned on the basis of Table 17 below.

**TABLE 17—ALTERNATIVE APPROACH BASED ON CREDIT SPREADS FOR ASSIGNING SPECIFIC RISK-WEIGHTING FACTORS TO SECURITIZATION POSITIONS**

Score is			Specific risk-weighting factor is (in percent)
Less than	and	Greater than or equal to	
0.203 ...		N/A	1.6
0.741 ...		0.203	2.0
3.003 ...		0.741	2.8

**TABLE 17—ALTERNATIVE APPROACH BASED ON CREDIT SPREADS FOR ASSIGNING SPECIFIC RISK-WEIGHTING FACTORS TO SECURITIZATION POSITIONS—Continued**

Score is			Specific risk-weighting factor is (in percent)
Less than	and	Greater than or equal to	
5.870 ...		3.003	6.0
9.000 ...		5.870	34.0
N/A .....		9.000	100.0

To construct this methodology, three types of securitization exposures (automobiles, credit cards, and equipment) were examined, and the approach was also tested on securitizations backed by other asset classes, including commercial mortgage backed securities and residential mortgage backed securities. This analysis was conducted using different time periods, including before and after

the 2008 financial crisis. The analysis indicated that this alternative could yield a reasonable level of credit risk differentiation. However, the agencies chose not to propose this approach in this NPR due to concerns that reliable spread data on many securitization positions would not be readily available. As is the case with other spread-based approaches, the agencies recognize that securitization spreads may be affected by factors other than credit risk, such as illiquidity.

*Question 16: Is the spread-based methodology feasible for assigning securitization positions to specific risk-weighting factors? What are the particular types of securitization positions for which it is more or less feasible, and why?*

*Question 17: Would this alternative be more or less effective as a methodology for assigning specific risk-weighting factors for securitization positions than the proposed methodology using the SSFA? What difficulties or challenges would a bank have in assigning specific*

<sup>38</sup> The CDX.HY.B index is comprised of high-yield credit default swaps that have reference assets rated approximately "B" by external credit rating agencies.

<sup>39</sup> The excess spread over U.S. Treasuries is appropriate for fully funded/collateralized securitizations. In other cases, the variable *sp* should be derived from the securitization spread

and the level of collateralization which would be a proxy for the unfunded spread.

*risk-weighting factors for securitization positions under this approach?*

*Question 18: What limitations currently exist with respect to banks' ability to obtain reliable spread data for securitization positions, including illiquid positions? If this method is implemented, how could banks demonstrate to supervisors sufficient access to such information to use the methodology?*

#### Alternative Using a Third-Party Vendor Approach

The agencies also considered the approach used by the National Association of Insurance Commissioners for determining the regulatory capital requirements for certain securitization positions held by insurance companies. Under such an approach, the agencies would retain one or more third-party vendors to assign risk-based capital requirements for securitization positions. Working with the third-party vendor(s), the agencies would develop a rating system that would evaluate individual securitization positions based on expected loss or probability of default. Each securitization position could be evaluated on a quarterly or annual basis, and could be evaluated more frequently as appropriate, such as when economic conditions or other factors that could affect the performance of the underlying exposures or tranche changed.

The agencies are concerned that the employment of third-party vendors would have some of the same drawbacks as relying on credit rating agencies. Specifically, the agencies have concerns regarding the use of internal models; the limited number of vendors that possess the expertise and resources necessary to determine an appropriate rating for securitization positions; the potential for overreliance on third-party ratings; and the potential conflicts of interest where a vendor retained by the agencies remains engaged in the business of evaluating securitization positions for other clients.

*Question 19: Given concerns noted above, what would be the advantages and disadvantages of such an approach, particularly relative to the proposed SSFA approach?*

#### Alternative Permitting the SFA for Advanced Approaches Banks

Both the Basel II standardized and advanced approaches securitization frameworks use a hierarchy of approaches for measuring risk-based capital requirements for securitization exposures. Under the hierarchy of approaches, a bank must use a credit rating from an external credit

assessment institution (ECAI), when available. The 2009 revisions allow a bank that has been approved to use the Basel II internal-ratings based approach (IRB) to apply the SFA. However, the Basel II Accord permits use of the SFA only for unrated securitization positions.

The agencies propose to adopt the SSFA for use by all banks subject to the market risk capital rules. That is, the SFA would not be an option available to advanced approaches banks within the market risk capital rules. The agencies expect that banks should be able to calculate the SSFA. Given concern about potential arbitrage opportunities that would be created if advanced approaches banks were allowed the option to use either the SSFA or the SFA to calculate specific risk capital requirements for their securitization positions, the agencies propose to permit advanced approaches banks to use only the SSFA for purposes of calculating the specific risk-weighting factors for their securitization positions.

*Question 20: Should banks that are approved to use the advanced approaches be allowed to use the advanced approaches SFA to calculate specific risk-weighting factors for their securitization positions under the market risk capital rules? If the advanced approaches banks are permitted to use SFA, what safeguards should be put in place to mitigate arbitrage concern?*

If the agencies were to allow the use of the SFA for assigning specific risk-weighting factors, the agencies would also consider modifications to the SFA to make it more risk-sensitive and more usable.

Under the advanced approaches rule, banks are allowed to use the SFA to calculate regulatory capital requirements for securitization positions if certain conditions are met.<sup>40</sup> The SFA requires banks to use exposure-specific inputs, including the capital requirement of the underlying exposures calculated under the agencies' advanced approaches rule as if the assets were held directly on a bank's balance sheet. The SFA was designed to allow banks to calculate capital requirements on unrated securitization positions that were originated by the banks holding the exposures. During the ANPR comment period and subsequent interaction with the industry, members of the industry indicated that banks generally do not possess the information

necessary to assign a probability of default and loss given default, and hence calculate a capital requirement, for individual wholesale exposures or segments of retail exposures where the underlying securitized positions were not originated by the bank. The commenters proposed that the agencies could modify the methodology for calculating SFA inputs by allowing banks to incorporate pool-level estimates of PD and LGD. To increase risk sensitivity of the approach, pool-level inputs could be used on a quarterly basis.

Although the SFA recognizes credit enhancement provided by funded subordinated positions in a securitization, it does not recognize as a form of credit enhancement additional cash flows available to a securitization from payment of principal and interest. One commenter indicated that the inability to recognize additional cash flows understates the credit enhancement available to certain securitizations, especially automobile and credit card securitizations. Furthermore, this could create competitive issues for U.S. banks in comparison to foreign banks that use the ratings-based approach and internal assessment approach, which may recognize the impact of additional cash flows. In order to address this issue, the commenter proposed allowing the use of cash flow projections to inform the level of credit enhancement recognized under the SFA.

*Question 21: How could the SFA be modified to permit the use of pool-level inputs to increase the applicability of the SFA for banks as investors? What effect would the use of pool-level inputs and the recognition of cash flow hedges have on the risk sensitivity of the SFA? To what extent does use of pool-level inputs camouflage the risk inherent in an asset pool? Are there other issues that should be considered if pool-level inputs are used?*

#### Comparing Capital Frameworks Pursuant to Section 171(b) of the Dodd-Frank Act

Pursuant to section 171(b) of the Act, the agencies may not establish generally applicable minimum risk-based capital requirements that are quantitatively lower than the generally applicable risk-based capital requirements that were in effect for insured depository institutions as of July 21, 2010.

The market risk capital rules' capital requirements, which were in effect on July 21, 2010, are part of the generally applicable risk-based capital requirements. Therefore, the agencies have considered the effect of

<sup>40</sup> See 12 CFR part 3, Appendix C section 45 (OCC); 12 CFR part 208, Appendix F, section 45 and 12 CFR part 225, Appendix G, section 45 (Board); 12 CFR part 325, Appendix D, section 45 (FDIC).

implementing the proposed alternatives to credit ratings under the agencies' market risk capital rules.

The agencies believe that the proposed changes to the market risk capital rules would not result in minimum capital requirements that are quantitatively lower than the generally applicable requirements for insured depository institutions in effect on July 21, 2010. In this regard, the agencies note that under this proposal, the specific risk capital requirements for debt and securitization positions should increase relative to the capital requirements for those positions under the existing market risk capital rules as of July 21, 2010.

### Regulatory Analysis

#### Regulatory Flexibility Act Analysis

The Regulatory Flexibility Act, 5 U.S.C. 601 *et seq.* (RFA), generally requires that, in connection with a notice of proposed rulemaking, an agency prepare and make available for public comment an initial regulatory flexibility analysis that describes the impact of a proposed rule on small entities.<sup>41</sup> Under regulations issued by the Small Business Administration,<sup>42</sup> a small entity includes a commercial bank or bank holding company with assets of \$175 million or less (a small banking organization). As of June 30, 2011, there were approximately 2,450 small bank holding companies, 648 small national banks, 499 small state member banks, and 2,554 small state nonmember banks.

The proposed rule would apply only if the bank holding company or bank has aggregated trading assets and trading liabilities equal to 10 percent or more of quarter-end total assets, or \$1 billion or more. No small banking organizations satisfy these criteria. Therefore, no small entities would be subject to this rule.

#### OCC Unfunded Mandates Reform Act of 1995 Determination

Section 202 of the Unfunded Mandates Reform Act of 1995, Public Law 104-4 (UMRA) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in the expenditure by state, local, and tribal governments, in the aggregate, or by the private sector of \$100 million or more (adjusted annually for inflation) in any one year. If a budgetary impact statement is required, section 205 of the UMRA also requires an agency to identify and consider a

reasonable number of regulatory alternatives before promulgating a rule.

The OCC estimates that the overall cost of the proposed rule in the first year of implementation will be approximately \$7.4 million. Eliminating start-up costs after the first year, we expect the annual cost in subsequent years to be roughly half of the start-up costs for data acquisition, calculation, and verification. We estimate this ongoing cost at approximately \$1.3 million.

The OCC also recognizes that market risk capital requirements are likely to change under the proposed rule. The largest capital impact of the proposed rule is likely to affect securitizations, corporate debt positions, and exposures to sovereigns. The increased risk sensitivity of the alternative measures of creditworthiness implies that specific risk capital requirements may go down for some trading assets and up for others. For those assets with a higher specific risk capital charge under the proposed rule, however, that increase is likely to be large, in some instances requiring a dollar-for-dollar capital charge.

At this time the OCC is unable to estimate the capital impact of this NPR with precision. While the impact on certain items (for example, U.S. Treasury Securities) will be zero, the impact on the other asset categories is less clear. For example, the actual impact on the specific risk capital requirements for a bank's holdings of corporate debt securities will depend on the quality of the assets as determined by the measures of creditworthiness set forth in the NPR. While the OCC anticipates that this impact may be large, the agency lacks the information on the composition and quality of the trading portfolio that would allow us to estimate a likely capital charge. The actual impact on market risk capital requirements also will depend on the extent to which institutions model specific risk.

For the January 2011 proposal, the OCC derived its estimate of the proposal's potential effect on market risk capital requirements using the third trading book impact study conducted by the Basel Committee on Banking Supervision in 2009 and additional estimates of the capital requirement for standardized securitization exposures and correlation trading positions.<sup>43</sup> Based on those assessments, the OCC estimated that the market risk capital

requirements for national banks would increase by approximately \$51 billion. These new capital requirements would lead banks to deleverage and lose the tax advantage of debt. Therefore, the OCC estimated that the loss of these tax benefits would be approximately \$334 million per year. Because the estimated cost of the January 2011 proposal exceeded \$100 million annually, the OCC prepared a budgetary impact analysis and identified and considered alternative approaches.<sup>44</sup>

Because the OCC expects that the alternative measures of creditworthiness set forth in this NPR will produce specific risk capital requirements that are comparable to those published by the Basel Committee, the OCC does not expect increased market risk capital requirements due to this NPR to differ substantially from our previous estimate. Thus, the OCC has not included an additional cost of capital component in this assessment, and the overall estimate of the cost of the proposed rule for national banks is \$7.4 million in the first year.

Because the OCC has determined that its portion of this NPR would not result in expenditures by state, local, and tribal governments, or by the private sector, of \$100 million or more, the OCC has not prepared a new budgetary impact statement or specifically addressed any new regulatory alternatives.

#### Paperwork Reduction Act

In accordance with the requirements of the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3501-3521), the agencies may not conduct or sponsor, and the respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number. The agencies have reviewed the proposed rulemaking and determined that there are no additional PRA requirements other than those previously identified in a related proposed rulemaking published on January 11, 2011 (76 FR 1890). The agencies sought public comment on these PRA requirements as part of the January proposed rulemaking and no comments were received on the PRA requirements.

#### Plain Language

Section 722 of the GLBA required the agencies to use plain language in all proposed and final rules published after January 1, 2000. The agencies invite comment on how to make this proposed rule easier to understand. For example:

<sup>43</sup> The report, "Analysis of the third trading book impact study", is available at [www.bis.org/publ/bcbs163.htm](http://www.bis.org/publ/bcbs163.htm). The study gathered data from 43 banks in 10 countries, including six banks from the United States.

<sup>44</sup> See 76 FR 1908 (January 11, 2011).

<sup>41</sup> See 5 U.S.C. 603(a).

<sup>42</sup> See 13 CFR 121.201.

- Have the agencies organized the material to suit your needs? If not, how could they present the rule more clearly?
- Are the requirements in the rule clearly stated? If not, how could the rule be more clearly stated?
- Do the regulations contain technical language or jargon that is not clear? If so, which language requires clarification?
- Would a different format (grouping and order of sections, use of headings, paragraphing) make the regulation easier to understand? If so, what changes would achieve that?
- Is this section format adequate? If not, which of the sections should be changed and how?
- What other changes can the agencies incorporate to make the regulation easier to understand?

**The Text of the Proposed Common Rules (All Agencies)**

The text of the further amendments to the proposed common rules published January 11, 2011, at 76 FR 1912 through 1920, consisting of the proposed addition of new definitions to Section 2 in alphabetical order, addition of Schedule A to Section 2, and a revised Section 10, is set forth below:

**Appendix to Part—Risk-Based Capital Guidelines; Market Risk Adjustment**

\* \* \* \* \*

**Section 2. Definitions**

\* \* \* \* \*

*Affiliate* with respect to a company means any company that controls, is controlled by, or is under common control with, the company.

\* \* \* \* \*

*Control* A person or company controls a company if it

(1) Owns, controls, or holds with power to vote 25 percent or more of a class of voting securities of the company; or

(2) Consolidates the company for financial reporting purposes.

\* \* \* \* \*

*Corporate debt position* means a debt position that is an exposure to a company that is not a sovereign entity, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, a multilateral development bank, a depository institution, a foreign bank, a credit union, a public sector entity, a government sponsored entity, or a securitization.

\* \* \* \* \*

*Country risk classification (CRC)* for a sovereign entity means the consensus CRC published from time to time by the Organization for Economic Cooperation and Development that provides a view of the likelihood that the sovereign entity will service its external debt.

\* \* \* \* \*

*Credit derivative* means a financial contract executed under standard industry documentation that allows one party (the protection purchaser) to transfer the credit risk of one or more exposures (reference exposure(s)) to another party (the protection provider).

*Credit union* means an insured credit union as defined under the Federal Credit Union Act (12 U.S.C. 1752).

*Cumulative losses* means the dollar amount of aggregate losses on the underlying exposures, net of recoveries, since deal closing or origination of a securitization.

\* \* \* \* \*

*Debt-to-assets ratio* means a ratio calculated by dividing a public company's total liabilities by the sum of its equity market value and total liabilities as reported as of the end of the most recent calendar quarter.

\* \* \* \* \*

*Default by a sovereign entity* means noncompliance by the sovereign entity with its external debt service obligations or the inability or unwillingness of a sovereign entity to service an existing obligation according to its original contractual terms, as evidenced by failure to pay principal and interest timely and fully, arrearages, or restructuring.

\* \* \* \* \*

*EBITDA-to-assets ratio* means a ratio calculated by dividing:

(1) A corporate entity's cumulative earnings over the previous four quarters before interest expense, taxes, depreciation and amortization (EBITDA) using data from the four most recently reported calendar quarters; by

(2) Its equity market value plus total liabilities as reported as of the end of the most recent calendar quarter.

*Equity market value* means the sum of:

(1) The number of outstanding shares as of the end of the most recent calendar quarter multiplied by the company's stock price on the last trading day of the most recent calendar quarter; and

(2) The measure of liabilities reported as of the end of the most recent calendar quarter.

\* \* \* \* \*

*Financial institution* means

(1) A commodity pool as defined in section 1a(10) of the Commodity Exchange Act (7 U.S.C. 1a(10));

(2) A private fund as defined in section 202(a) of the Investment Advisors Act of 1940 (15 U.S.C. 80-b-2(a)); except for small business investment companies, as defined in section 102 of the Small Business Investment Act of 1958 (15 U.S.C. 662), or a private fund designed primarily to promote the public welfare, of the type permitted under section 24 (Eleventh) of the National Bank Act (12 U.S.C. 24 (Eleventh)) and 12 CFR part 24;

(3) An employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974 (29 U.S.C. 1002);

(4) A bank holding company, depository institution, foreign bank, credit union, insurance company, securities firm, other than an entity designated as a Community

Development Financial Institution (CDFI) under 12 U.S.C. 4701 *et seq.* and 12 CFR part 1805;

(5) Any other company predominantly engaged in activities that are in the business of banking under section 24 (Seventh) of the National Bank Act (12 U.S.C. 24), or in activities that are financial in nature under section 4(k) of the Bank Holding Company of 1956 (12 U.S.C. 1843(k)) as of the date this subpart becomes effective (collectively, "financial activities"); provided that, if the company is not an affiliate of the [banking organization] calculating its capital requirements under this appendix, then the [banking organization] may exclude activities set forth on Schedule A when determining whether the company is predominantly engaged in financial activities.

(6) Any non-U.S. entity that would be covered by any of paragraphs (1) through (5) of this definition if such entity was organized in the United States; or

(7) Any other company that the [AGENCY] may determine is a financial institution based on the nature and scope of its activities.

(8) For the purposes of this part, a company is "predominantly engaged" in financial activities, if:

(i) 85 percent or more of the total consolidated annual gross revenues (as determined in accordance with applicable accounting standards) of the company in either of the two most recent calendar years were derived, directly or indirectly, by the company on a consolidated basis from financial activities; or

(ii) 85 percent or more of the company's consolidated total assets (as determined in accordance with applicable accounting standards) as of the end of either of the two most recent calendar years were related to financial activities.

*Foreign bank* means a foreign bank as defined in § 211.2 of the Federal Reserve Board's Regulation K (12 CFR 211.2) other than a depository institution.

\* \* \* \* \*

*General obligation* means a bond or similar obligation that is guaranteed by the full faith and credit of states or other political subdivisions of a sovereign entity.

*Government sponsored entity (GSE)* means an entity established or chartered by the U.S. government to serve public purposes specified by the U.S. Congress but whose debt obligations are not explicitly guaranteed by the full faith and credit of the U.S. government.

\* \* \* \* \*

*Multilateral development bank (MDB)* means the International Bank for Reconstruction and Development, the Multilateral Investment Guarantee Agency, the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the European Investment Fund, the Nordic Investment Bank, the Caribbean Development Bank, the Islamic Development Bank, the Council of Europe Development Bank, and any other multilateral lending institution or regional development bank in

which the U.S. government is a shareholder or contributing member or which the [AGENCY] determines poses comparable credit risk.

\* \* \* \* \*

*Private company* means a company that is not a public company.

*Public company* means a company that has issued common shares or equivalent equity instruments that are publicly traded.

\* \* \* \* \*

*Public sector entity (PSE)* means a state, local authority, or other governmental subdivision below the sovereign entity level.

*Publicly traded* means traded on:

(1) Any exchange registered with the SEC as a national securities exchange under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f); or

(2) Any non-U.S.-based securities exchange that:

(i) Is registered with, or approved by, a national securities regulatory authority; and

(ii) Provides a liquid, two-way market for the instrument in question, meaning that there are enough independent bona fide offers to buy and sell so that a sales price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined promptly and a trade can be settled at such a price within five business days.

\* \* \* \* \*

*Revenue obligation* means a bond or similar obligation, including loans and leases, that is an obligation of a state or other political subdivision of a sovereign entity, but for which the government entity is committed to repay with revenues from the specific project financed rather than with general tax funds.

\* \* \* \* \*

*Sovereign debt position* means a direct exposure to a sovereign entity.

\* \* \* \* \*

*Sovereign of incorporation* means the country where an entity is incorporated, chartered, or similarly established

\* \* \* \* \*

*Stock return volatility measure* means the annual volatility of the corporate entity's monthly stock returns calculated as the standard deviation of the monthly stock returns calculated using prices as of the last trading day of each month over the preceding 12 months, adjusted for stock splits.

*Underlying exposure* means one or more exposures that have been securitized in a securitization transaction.

## Schedule A to Section 2

*Acting as a certification authority for digital signatures.* Providing services designed to verify or authenticate the identity of customers conducting financial and non-financial transactions over the Internet and other "open" electronic networks.

*Administrative and related services to mutual funds.* Providing administrative and related services to mutual funds.

*ATM sales to banks and ATM services.* Purchasing ATMs for resale to banks, and providing services for banks in the ATM network.

*Career counseling services.* Providing career counseling services to:

(1) A financial organization and individuals currently employed by, or recently displaced from, a financial organization;

(2) Individuals who are seeking employment at a financial organization; and

(3) Individuals who are currently employed in or who seek positions in the finance, accounting, and audit departments of any company.

*Coins, buying and selling.* Buying and selling privately minted commemorative coins.

*Collection agency services.* Collecting overdue accounts receivable, either retail or commercial.

*Community development activities.*

(1) Making equity and debt investments in corporations or projects designed primarily to promote community welfare, such as the economic rehabilitation and development of low-income areas by providing housing, services, or jobs for residents, including any investment of the type permitted under section 24 (Eleventh) of the National Bank Act (12 U.S.C. 24 (Eleventh)) and 12 CFR part 24; and

(2) Providing advisory and related services for programs designed primarily to promote community welfare.

*Courier services.* Providing courier services for:

(1) Checks, commercial papers, documents, and written instruments (excluding currency or bearer-type negotiable instruments) that are exchanged among banks and financial institutions; and

(2) Audit and accounting media of a banking or financial nature and other business records and documents used in processing such media.

*Credit bureau services.* Maintaining information related to the credit history of consumers and providing the information to a credit grantor who is considering a borrower's application for credit or who has extended credit to the borrower.

*Data processing.*

(1) Providing data processing and data transmission services; facilities (including data processing and data transmission hardware, software, documentation, or operating personnel); databases; advice; and access to services, facilities, or databases by any technological means if the data to be processed, stored or furnished are financial, banking, or economic; and

(2) Conducting data processing and data transmission activities not described above that are not financial, banking, or economic.

*Development of marketing plans and materials for mutual funds.* Developing marketing plans and the preparation of advertising, sales literature, and marketing materials for mutual funds.

*Employee benefits consulting services.* Providing consulting services to employee benefit, compensation and insurance plans, including designing plans, assisting in the implementation of plans, providing administrative services to plans, and developing employee communication programs for plans.

*Financial and investment advisory activities.* Acting as an investment adviser or financial adviser to any person, including:

(1) Serving as an investment adviser to an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80b-3) including sponsoring, organizing, and managing a closed-end investment company;

(2) Furnishing general economic information and advice, general economic statistical forecasting services, and industry studies;

(3) Providing advice in connection with mergers, acquisitions, divestitures, investments, joint ventures, leveraged buyouts, reorganizations, recapitalizations, capital structurings, financing transactions, and similar transactions, and conducting financial feasibility studies;

(4) Providing information, statistical forecasting, and advice with respect to any transaction in foreign exchange, swaps and similar transactions, commodities, and any forward contract, option, future, option on a future, and similar instruments;

(5) Providing educational courses and instructional materials to consumers on individual financial-management matters; and

(6) Providing tax-planning and tax-preparation services to any person.

*Finder activities.* Acting as a finder in bringing together one or more buyers and sellers of any product or service for transactions that the parties themselves negotiate and consummate.

*Investment in companies that develop, distribute and support software.* Investing and taking warrants in companies that develop, distribute, and support software that enables secure payments over the Internet.

*Leasing personal or real property.* Leasing personal or real property or acting as agent, broker, or adviser in leasing such property.

*Management consulting and counseling activities.* Providing management consulting advice:

(1) On any matter to unaffiliated depository institutions, including commercial banks, savings and loan associations, savings banks, credit unions, industrial banks, Morris Plan banks, cooperative banks, industrial loan companies, trust companies, and branches or agencies of foreign banks; and

(2) On any financial, economic, accounting, or audit matter to any other company.

*Money orders, savings bonds, and traveler's checks.* The issuance and sale at retail of money orders and similar consumer-type payment instruments; the sale of U.S. savings bonds; and the issuance and sale of traveler's checks.

*Operating a travel agency.* Operating a travel agency in connection with financial services.

*Printing and selling MICR-encoded checks and related documents.* Printing and selling checks and related documents, including corporate image checks, cash tickets, voucher checks, deposit slips, savings withdrawal packages, and other forms that require Magnetic Ink Character Recognition (MICR) encoding.

*Providing employment histories to third parties.* Providing employment histories to

third-party credit grantors, including depository and nondepository grantors, for use in making decisions to extend credit, and to third-party depository institutions and their affiliates, including credit unions and their affiliates for use in the regular course of their business, including the hiring of employees.

*Real estate and personal property appraising.* Performing appraisals of real estate and tangible and intangible personal property, including securities.

*Real estate settlement servicing.* Providing real estate settlement services, including through a title insurance agency.

*Real estate title abstracting.* Reporting factual information concerning the interests or ownership of selected real property.

*Sales-tax refund agency activities.* Acting as a sales-tax refund agent on behalf of state and local governments.

*Sale of government services.* Sale of government services involving:

(1) Postage stamps and postage-paid envelopes;

(2) Public transportation tickets and tokens;

(3) Vehicle registration services (including the sale and distribution of license plates and license tags for motor vehicles); and

(4) Notary public services.

*Sale or license of corporate credit card data processing software.* Purchasing for resale or licensing data processing software designed to monitor corporate credit card usage, merge usage data, generate invoices, and approve/make payments.

*Sale of Web site software and other Web site hosting services.* Selling Web site editing software as part of a bundle of internet-based Web site hosting services for bank customers; and developing new software products to be used in conjunction with transaction processing services and in developing Internet-based services.

*Software development and production.* Engaging in joint ventures to develop and distribute home banking and financial management software to be distributed through banks and through retail outlets.

*Title insurance agency activities.* Operating a title insurance agency.

\* \* \* \* \*

**Section 10. Standardized Measurement Method for Specific Risk**

(a) *General requirement.* A [banking organization] must calculate a total specific

risk add-on for each portfolio of debt and equity positions for which the [banking organization]'s VaR-based measure does not capture all material aspects of specific risk and for all securitization positions that are not modeled under section 9 of this rule. A [banking organization] must calculate each specific risk add-on in accordance with the requirements of this section.

(1) The specific risk add-on for an individual debt or securitization position that represents purchased credit protection is capped at the market value of the position.

(2) For debt, equity, or securitization positions that are derivatives with linear payoffs, a [banking organization] must assign a specific risk-weighting factor to the market value of the effective notional amount of the underlying instrument or index portfolio. A swap must be included as an effective notional position in the underlying instrument or portfolio, with the receiving side treated as a long position and the paying side treated as a short position. For debt, equity, or securitization positions that are derivatives with nonlinear payoffs, a [banking organization] must risk weight the market value of the effective notional amount of the underlying instrument or portfolio multiplied by the derivative's delta.

(3) For debt, equity, or securitization positions, a [banking organization] may net long and short positions (including derivatives) in identical issues or identical indices. A [banking organization] may also net positions in depository receipts against an opposite position in an identical equity in different markets, provided that the [banking organization] includes the costs of conversion.

(4) A set of transactions consisting of either a debt position and its credit derivative hedge or a securitization position and its credit derivative hedge has a specific risk add-on of zero if the debt or securitization position is fully hedged by a total return swap (or similar instrument where there is a matching of swap payments and changes in market value of the debt or securitization position) and there is an exact match between the reference obligation of the swap and the debt or securitization position, the maturity of the swap and the debt or securitization position, and the currency of the swap and the debt or securitization position.

(5) The specific risk add-on for a set of transactions consisting of either a debt

position and its credit derivative hedge or a securitization position and its credit derivative hedge that does not meet the criteria of paragraph (a)(4) of this section is equal to 20.0 percent of the capital requirement for the side of the transaction with the higher capital requirement when the credit risk of the position is fully hedged by a credit default swap or similar instrument and there is an exact match between the reference obligation of the credit derivative hedge and the debt or securitization position, the maturity of the credit derivative hedge and the debt or securitization position, and the currency of the credit derivative hedge and the debt or securitization position.

(6) The specific risk add-on for a set of transactions consisting of either a debt position and its credit derivative hedge or a securitization position and its credit derivative hedge that does not meet the criteria of either paragraph (a)(4) or (a)(5) of this section, but in which all or substantially all of the price risk has been hedged, is equal to the specific risk add-on for the side of the transaction with the higher specific risk add-on.

(b) *Debt and securitization positions.* (1) Unless otherwise provided in paragraph (b)(3) of this section, the total specific risk add-on for a portfolio of debt or securitization positions is the sum of the specific risk add-ons for individual debt or securitization positions, as computed under this section. To determine the specific risk add-on for individual debt or securitization positions, a [banking organization] must multiply the absolute value of the current market value of each net long or net short debt or securitization position in the portfolio by the appropriate specific risk-weighting factor as set forth in paragraphs (b)(2)(i) through (b)(2)(vii) of this section.

(2) For the purpose of this section, the appropriate specific risk-weighting factors include:

(i) *Sovereign debt positions.* (A) *In general.* A [banking organization] must assign a specific risk-weighting factor to a sovereign debt position based on the CRC applicable to the sovereign entity in accordance with Table 2.

(1) Sovereign debt positions that are backed by the full faith and credit of the United States are to be treated as having a CRC rating of 0.

TABLE 2—SPECIFIC RISK-WEIGHTING FACTORS FOR SOVEREIGN DEBT POSITIONS

Sovereign CRC	Specific risk-weighting factor (in percent)	
0–1	0.0	
2–3	Residual term to final maturity 6 months or less	0.25
	Residual term to final maturity greater than 6 months and up to and including 24 months.	1.0
	Residual term to final maturity exceeding 24 months	1.6
4–6	8.0	
7	12.0	
No CRC	8.0	

(B) Notwithstanding paragraph (b)(2)(i)(A) of this section, a [banking organization] may assign to a sovereign debt position a specific risk-weighting factor that is lower than the applicable specific risk-weighting factor in Table 2 if:

- (1) The position is denominated in the sovereign entity's currency;
  - (2) The [banking organization] has at least an equivalent amount of liabilities in that currency; and
  - (3) The sovereign entity allows banks under its jurisdiction to assign the lower specific risk-weighting factor to the same exposures to the sovereign entity.
- (C) A [banking organization] must assign a 12.0 percent specific risk-weighting factor to a sovereign debt position (1) immediately upon determination that the sovereign entity has defaulted on any outstanding sovereign

debt position, or (2) if the sovereign entity has defaulted on any sovereign debt position during the previous five years.

(D) A [banking organization] must assign an 8.0 percent specific risk-weighting factor to a sovereign debt position if the sovereign entity does not have a CRC assigned to it, unless the sovereign debt position must be assigned a higher specific risk-weighting factor under paragraph (b)(2)(i)(C) of this section.

(ii) *Certain supranational entity and multilateral development bank debt positions.* A [banking organization] may assign a 0.0 percent specific risk-weighting factor to a debt position that is an exposure to the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, or an MDB.

(iii) *GSE debt positions.* A [banking organization] must assign a 1.6 percent specific risk-weighting factor to a debt position that is an exposure to a GSE. Notwithstanding the forgoing, a [banking organization] must assign an 8.0 percent specific risk-weighting factor to preferred stock issued by a GSE.

(iv) *Depository institution, foreign bank, and credit union debt positions.* (A) Except as provided in paragraph (b)(2)(iv)(B) of this section, a [banking organization] must assign a specific risk-weighting factor to a debt position that is an exposure to a depository institution, a foreign bank, or a credit union using the specific risk-weighting factor that corresponds to that entity's sovereign of incorporation in accordance with Table 3.

TABLE 3—SPECIFIC RISK-WEIGHTING FACTORS FOR DEPOSITORY INSTITUTION, FOREIGN BANK, AND CREDIT UNION DEBT POSITIONS

CRC of Sovereign of Incorporation	Specific risk-weighting factor (in percent)	
0–2 .....	Residual term to final maturity 6 months or less .....	0.25
	Residual term to maturity up to and including 24 months .....	1.0
	Residual term to final maturity exceeding 24 months .....	1.6
3 .....	8.0	
4–7 .....	12.0	
No CRC .....	8.0	

(B) A [banking organization] must assign a specific risk-weighting factor of 8.0 percent to a debt position that is an exposure to a depository institution or a foreign bank that is includable in the depository institution's or foreign bank's regulatory capital and that is not subject to deduction as a reciprocal holding pursuant to 12 CFR part 3, appendix A, section 2(c)(6)(ii) (national banks); 12 CFR part 208, appendix A, section II.B.3 (state member banks); 12 CFR part 225, appendix A, section II.B.3 (bank holding companies); 12 CFR part 325, appendix A, section I.B.(4)

(state nonmember banks); and 12 CFR part 167.5(c)(2)(i) (savings associations).

(v) *PSE debt positions.* (A) Except as provided in paragraph (b)(2)(v)(B) of this section, a [banking organization] must assign a risk-weighting factor to a debt position that is an exposure to a PSE based on the specific risk-weighting factor that corresponds to the PSE's sovereign of incorporation and to the position's categorization as a general obligation or revenue obligation, as set forth in Tables 4 and 5.

(B) A [banking organization] may assign a lower specific risk-weighting factor than would otherwise apply under Table 4 to a debt position that is an exposure to a foreign PSE if:

- (1) The PSE's sovereign of incorporation allows banks under its jurisdiction to assign a lower specific risk-weighting factor to such position; and
- (2) The specific risk-weighting factor is not lower than the risk-weight that corresponds to the PSE's sovereign of incorporation in accordance with Table 4.

TABLE 4—SPECIFIC RISK-WEIGHTING FACTORS FOR PSE GENERAL OBLIGATION DEBT POSITIONS

Sovereign Entity CRC	General obligation specific risk-weighting factor (in percent)	
0–2 .....	Residual term to final maturity 6 months or less .....	0.25
	Residual term to maturity up to and including 24 months .....	1.0
	Residual term to final maturity exceeding 24 months .....	1.6
3 .....	8.0	
4–7 .....	12.0	
No CRC .....	8.0	

TABLE 5—SPECIFIC RISK-WEIGHTING FACTORS FOR PSE REVENUE OBLIGATION DEBT POSITIONS

Sovereign Entity CRC	Revenue obligation specific risk-weighting factor (in percent)	
0–1 .....	Residual term to final maturity 6 months or less .....	0.25
	Residual term to maturity up to and including 24 months .....	1.0
	Residual term to final maturity exceeding 24 months .....	1.6

TABLE 5—SPECIFIC RISK-WEIGHTING FACTORS FOR PSE REVENUE OBLIGATION DEBT POSITIONS—Continued

2-3 .....	8.0
4-7 .....	12.0
No CRC .....	8.0

(vi) *Corporate debt positions.* A [banking organization] must assign a specific risk-weighting factor to a corporate debt position in accordance with the methodologies in paragraph (b)(2)(vi)(A) or (b)(2)(vi)(B) of this section provided that the [banking organization] consistently applies the same methodology to all corporate debt positions.

(A) *Simple methodology.* A [banking organization] that uses the simple methodology must assign a specific risk-weighting factor of 8.0 percent to all of its corporate debt positions.

(B) *Indicator-based methodology.* A [banking organization] that elects to use the indicator-based methodology must assign a specific risk-weighting factor to its corporate debt positions in accordance with paragraphs (b)(2)(vi)(B)(1) through (b)(2)(vi)(B)(4) of this section.

(1) *Debt positions in a public company that is not a financial institution.* A [banking organization] must assign a specific risk-weighting factor to a corporate debt position that is an exposure to a public company that is not a financial institution, as set forth in

Table 6, corresponding with the results of the following calculations, using the most recently available data reported by the company:

- (i) The EBITDA-to-assets ratio for the company;
- (ii) The debt-to-assets ratio for the company; and
- (iii) The stock return volatility measure for the company.

TABLE 6—SPECIFIC RISK-WEIGHTING FACTORS FOR NON-FINANCIAL PUBLICLY-TRADED COMPANY DEBT POSITIONS

EBITDA-to-assets ratio	Stock return volatility measure	Specific risk-weighting factor (in percent)		
		Debt-to-assets ratio less than 0.2	Debt-to-assets ratio between 0.2 and 0.5	Debt-to-assets ratio greater than 0.5
Greater than zero .....	less than 0.1 .....	[ <sup>1</sup> ]	8.0	8.0
	between 0.1 and 0.15 .....	8.0	8.0	8.0
	greater than 0.15 .....	8.0	8.0	12.0
Less than zero .....	less than 0.1 .....	8.0	8.0	8.0
	between 0.1 and 0.15 .....	8.0	8.0	12.0
	greater than 0.15 .....	12.0	12.0	12.0

<sup>1</sup> See Table 6A.

TABLE 6A—SPECIFIC RISK-WEIGHTING FACTORS FOR CERTAIN NON-FINANCIAL PUBLICLY-TRADED COMPANY DEBT POSITIONS

Remaining contractual maturity	Specific risk-weighting factor (in percent)
Residual term to final maturity 6 months or less .....	0.25
Residual term to final maturity greater than 6 months and up to and including 24 months .....	1.0
Residual term to final maturity exceeding 24 months .....	1.6

(2) *Financial institution debt position.* A [banking organization] must assign an 8.0 percent specific risk-weighting factor to a corporate debt position that is an exposure to a financial institution that is not a depository institution, foreign bank, or credit union.

(3) *Debt positions in a private company that is not a financial institution.* A [banking organization] must assign an 8.0 percent specific risk-weighting factor to a corporate debt position that is an exposure to a private company that is not a financial institution.

(4) *Insufficient information.* If a [banking organization] does not have sufficient information to determine the appropriate

specific risk-weighting factor for a corporate debt position under paragraphs (b)(2)(vi)(B)(1) through (b)(2)(vi)(B)(3) of this section, the [banking organization] must assign an 8.0 percent specific risk-weighting factor to the position.

(C) *Limitations.* (1) A [banking organization] must assign a specific risk-weighting factor of at least 8.0 percent to an interest-only mortgage-backed security that is not a securitization position.

(2) A [banking organization] shall not assign a corporate debt position a specific risk-weighting factor that is lower than the specific risk-weighting factor that corresponds to the CRC rating of the obligor's sovereign of incorporation in Table 2.

(vii) *Securitization positions.* A [banking organization] may assign a specific risk-weighting factor to a securitization position using the simplified supervisory formula approach (SSFA) in accordance with this paragraph (vii). A [banking organization] that elects not to use the SSFA for a securitization position must assign a specific risk-weighting factor of 100 percent to the position.

(A) To use the SSFA to determine the specific risk-weighting factor for a securitization position, including re-securitization and synthetic securitization positions, a [banking organization] must have information that enables it to assign accurately the parameters described in paragraph (b)(2)(vii)(B) of this section. The [banking organization] also must have and maintain appropriate data to measure the cumulative losses for the underlying

exposures. Data used to assign the parameters described in paragraph (b)(2)(vii)(B) and the cumulative losses must be the most currently available data and no more than 91 calendar days old. A [banking organization] that does not have the appropriate data to assign the parameters described in paragraph (b)(2)(vii)(B) must assign a specific risk-weighting factor of 100 percent to the position.

(B) To calculate the specific risk-weighting factor for a securitization position, a [banking organization] must use the following four parameters:

(1)  $K_G$  is the weighted-average (with unpaid principal used as the weight for each exposure) total capital requirement of the underlying exposures calculated using [general risk-based capital rules].  $K_G$  is expressed as a decimal value between zero and 1 (that is, an average risk weight of 100 percent implies a value of  $K_G$  equal to .08);

(2) The parameter A is the attachment point for the position, which represents the threshold at which credit losses will first be allocated to the position. Parameter A equals the ratio of the current dollar amount of underlying exposures that are subordinated to the position the [banking organization] to the current dollar amount of underlying exposures. Any reserve account funded by the accumulated cash flows from the underlying exposures that is subordinated to the position that contains the [banking organization]'s securitization exposure may be included in the calculation of parameter A to the extent that cash is present in the

account. Parameter A is expressed as a decimal value between zero and one.

(3) The parameter D is the detachment point for the position, which represents the threshold at which credit losses of principal allocated to the position would result in a total loss of principal. Parameter D equals parameter A plus the ratio of the current dollar amount of the securitization positions that are *pari passu* with the position (that is, have equal seniority with respect to credit risk) to the current dollar amount of the underlying exposures. Parameter D is expressed as a decimal value between zero and one.

(4) A supervisory calibration parameter, p, equal to 0.5 for securitization positions that are not re-securitization positions and equal to 1.5 for re-securitization positions.

(C) *Mechanics of the SSFA.* The values of parameters A and D, relative to  $K_G$  determine the specific risk-weighting factor assigned to a position as described in this paragraph and paragraph (b)(2)(vii)(D) of this section. The specific risk-weighting factor assigned to a securitization position, or portion of a position, as appropriate, is the larger of the specific risk-weighting factor determined in accordance with this paragraph and paragraph (b)(2)(vii)(D) of this section and the specific risk-weighting factor determined in accordance with paragraph (b)(2)(vii)(E) of this section.

(1) When the detachment point, D, for a securitization position is less than or equal to  $K_G$ , the position must be assigned a specific risk-weighting factor of 100 percent.

(2) When the attachment point, A, for a securitization position is greater than or

equal to  $K_G$ , the [banking organization] must calculate the specific risk-weighting factor in accordance with sub-paragraphs (D)(1) and (D)(2) of this paragraph.

(3) When A is less than  $K_G$  and D is greater than  $K_G$ , the portion that lies below  $K_G$  must be assigned a specific risk-weighting factor of 100 percent and the [banking organization] must calculate the specific risk-weighting factor for the portion that lies above  $K_G$  in accordance with paragraphs (D)(1) and (D)(2) of this paragraph. For the purpose of this calculation:

(i) The portion that lies below  $K_G$  equals  $K_G$  minus A.

(ii) The portion that lies above  $K_G$  equals D minus  $K_G$ .

(D) *SSFA equation.* (1) Define the following parameters:

$$a = -\frac{1}{p \cdot K_G}$$

$$u = D - K_G$$

$$l = A - K_G$$

$e = 2.71828$ , the base of the natural logarithms.

(2) Then:

$$K_{SSFA} = \frac{e^{a \cdot u} - e^{a \cdot l}}{a(u - l)}$$

The specific risk-weighting factor for the position (expressed as a percent) is

equal to  $K_{SSFA} \times 100$ .

(E) *Limitations.* A [banking organization] must assign a minimum specific risk-weighting factor to a securitization position based on the cumulative losses as a percent of the original dollar value of  $K_G$  in accordance with Table 7.

TABLE 7—MINIMUM SPECIFIC RISK-WEIGHTING FACTOR FOR A POSITION

Cumulative losses of principal on originally issued securities as a percent of $K_G$ at origination		Minimum specific risk-weighting factor (in percent)
Greater than	Less than or equal to	
0	50	1.6
50	100	8.0
100	150	52.0
150	n/a	100.0

(3) *Nth-to-default credit derivatives.* The total specific risk add-on for a portfolio of

nth-to-default credit derivatives is the sum of the specific risk add-ons for individual nth-to-default credit derivatives, as computed under this paragraph. The specific risk add-on for each nth-to-default credit derivative position applies irrespective of whether a [banking organization] is a net protection buyer or net protection seller. A [banking organization] must calculate the specific risk add-on for each nth-to-default credit derivative as follows:

(i) First-to-default credit derivatives.

(A) The specific risk add-on for a first-to-default credit derivative is the lesser of:

(1) The sum of the specific risk add-ons for the individual reference credit exposures in the group of reference exposures; or

(2) The maximum possible credit event payment under the credit derivative contract.

(B) Where a [banking organization] has a risk position in one of the reference credit exposures underlying a first-to-default credit derivative and this credit derivative hedges the [banking organization]'s risk position, the [banking organization] is allowed to reduce

both the specific risk add-on for the reference credit exposure and that part of the specific risk add-on for the credit derivative that relates to this particular reference credit exposure such that its specific risk add-on for the pair reflects the bank's net position in the reference credit exposure. Where a [banking organization] has multiple risk positions in reference credit exposures underlying a first-to-default credit derivative, this offset is allowed only for the underlying reference credit exposure having the lowest specific risk add-on.

(ii) Second-or-subsequent-to-default credit derivatives.

(A) The specific risk add-on for a second-or-subsequent-to-default credit derivative is the lesser of:

(1) The sum of the specific risk add-ons for the individual reference credit exposures in the group of reference exposures, but disregarding the (n-1) obligations with the lowest specific risk add-ons; or

(2) The maximum possible credit event payment under the credit derivative contract.

(B) For second-or-subsequent-to-default credit derivatives, no offset of the specific risk add-on with an underlying reference credit exposure is allowed.

(c) *Modeled correlation trading positions.* For purposes of calculating the comprehensive risk measure for modeled correlation trading positions under either paragraph (a)(2)(i) or (a)(2)(ii) of section 9, the total specific risk add-on is the greater of:

(1) The sum of the [banking organization]'s specific risk add-ons for each net long correlation trading position calculated under this section; or

(2) The sum of the [banking organization]'s specific risk add-ons for each net short correlation trading position calculated under this section.

(d) *Non-modeled securitization positions.* For securitization positions that are not correlation trading positions and for securitizations that are correlation trading positions not modeled under section 9 of this rule, the total specific risk add-on is the greater of:

(1) The sum of the [banking organization]'s specific risk add-ons for each net long securitization position calculated under this section; or

(2) The sum of the [banking organization]'s specific risk add-ons for each net short securitization position calculated under this section.

(e) *Equity positions.* The total specific risk add-on for a portfolio of equity positions is the sum of the specific risk add-ons of the individual equity positions, as computed under this section. To determine the specific risk add-on of individual equity positions, a [banking organization] must multiply the absolute value of the current market value of each net long or net short equity position by the appropriate specific risk-weighting factor as determined under this paragraph.

(1) The [banking organization] must multiply the absolute value of the current market value of each net long or net short equity position by a specific risk-weighting factor of 8.0 percent. For equity positions that are index contracts comprising a well-diversified portfolio of equity instruments, the absolute value of the current market value of each net long or net short position is multiplied by a specific risk-weighting factor of 2.0 percent.<sup>45</sup>

(2) For equity positions arising from the following futures-related arbitrage strategies, a [banking organization] may apply a 2.0 percent specific risk-weighting factor to one side (long or short) of each position with the opposite side exempt from an additional capital requirement:

(i) Long and short positions in exactly the same index at different dates or in different market centers; or

(ii) Long and short positions in index contracts at the same date in different, but similar indices.

(3) For futures contracts on main indices that are matched by offsetting positions in a basket of stocks comprising the index, a

[banking organization] may apply a 2.0 percent specific risk-weighting factor to the futures and stock basket positions (long and short), provided that such trades are deliberately entered into and separately controlled, and that the basket of stocks is comprised of stocks representing at least 90.0 percent of the capitalization of the index. A main index refers to the Standard & Poor's 500 Index, the FTSE All-World Index, and any other index for which the [banking organization] can demonstrate to the satisfaction of the [AGENCY] that the equities represented in the index have liquidity, depth of market, and size of bid-ask spreads comparable to equities in the Standard & Poor's 500 Index and FTSE All-World Index.

(f) *Due diligence requirements.* (1) A [banking organization] must be able to demonstrate to the satisfaction of the [AGENCY] a comprehensive understanding of the features of a securitization position that would materially affect the performance of the position. The [banking organization]'s analysis must be commensurate with the complexity of the securitization position and the materiality of the position in relation to capital.

(2) To support the demonstration of its comprehensive understanding, for each securitization position a [banking organization] must:

(i) Conduct and document an analysis of the risk characteristics of a securitization position prior to acquiring the position, considering:

(A) Structural features of the securitization that would materially impact the performance of the position, for example, the contractual cash flow waterfall, waterfall-related triggers, credit enhancements, liquidity enhancements, market value triggers, the performance of organizations that service the position, and deal-specific definitions of default;

(B) Relevant information regarding the performance of the underlying credit exposure(s), for example, the percentage of loans 30, 60, and 90 days past due; default rates; prepayment rates; loans in foreclosure; property types; occupancy; average credit score or other measures of creditworthiness; average loan-to-value ratio; and industry and geographic diversification data on the underlying exposure(s);

(C) Relevant market data of the securitization, for example, bid-ask spreads, most recent sales price and historical price volatility, trading volume, implied market rating, and size, depth and concentration level of the market for the securitization; and

(D) For re-securitization positions, performance information on the underlying securitization exposures, for example, the issuer name and credit quality, and the characteristics and performance of the exposures underlying the securitization exposures; and

(ii) On an on-going basis (no less frequently than quarterly), evaluate, review, and update as appropriate the analysis required under paragraph (d)(1) of this section for each securitization position.

[End of Common Text]

## List of Subjects

### 12 CFR Part 3

Administrative practices and procedure, Capital, National banks, Reporting and recordkeeping requirements, Risk.

### 12 CFR Part 208

Confidential business information, Crime, Currency, Federal Reserve System, Mortgages, Reporting and recordkeeping requirements, Securities.

### 12 CFR Part 225

Administrative practice and procedure, Banks, banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

### 12 CFR Part 325

Administrative practice and procedure, Banks, banking, Capital Adequacy, Reporting and recordkeeping requirements, Savings associations, State non-member banks.

## Adoption of Common Rule

### Department of the Treasury

#### Office of the Comptroller of the Currency

#### 12 CFR Chapter I

#### Authority and Issuance

For the reasons set forth in the common preamble, the Office of the Comptroller of the Currency proposes to further amend part 3 of chapter I of title 12 of Code of Federal Regulations, as proposed to be amended January 11, 2011, at 76 FR 1912 and 1921, as follows:

### PART 3—MINIMUM CAPITAL RATIOS; ISSUANCE OF DIRECTIVES

1. The authority citation for part 3 continues to read as follows:

**Authority:** 12 U.S.C. 93a, 161, 1818, 1828(n), 1828 (note), 1831n note, 1835, 3907, and 3909.

2. Appendix B to part 3 is amended as set forth at the end of the common preamble.

### Board of Governors of the Federal Reserve System

#### 12 CFR Chapter II

#### Authority and Issuance

For the reasons set forth in the common preamble, the Board of Governors of the Federal Reserve System proposes to further amend parts 208 and 225 of chapter II of title 12 of the Code of Federal Regulations as proposed to be amended January 11,

<sup>45</sup> A portfolio is well-diversified if it contains a large number of individual equity positions, with no single position representing a substantial portion of the portfolio's total market value.

2011, at 76 FR 1912 and 1921, as follows:

**PART 208—MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM (REGULATION H)**

3. The authority citation for part 208 continues to read as follows:

**Authority:** 12 U.S.C. 24, 36, 92a, 93a, 248(a), 248(c), 321–338a, 371d, 461, 481–486, 601, 611, 1814, 1816, 1818, 1820(d)(9), 1833(j), 1828(o), 1831, 1831o, 1831p–1, 1831r–1, 1831w, 1831x, 1835a, 1882, 2901–2907, 3105, 3310, 3331–3351, and 3905–3909; 15 U.S.C. 78b, 78l(b), 78l(i), 780–4(c)(5), 78q, 78q–1, and 78w, 1681s, 1681w, 6801, and 6805; 31 U.S.C. 5318; 42 U.S.C. 4012a, 4104a, 4104b, 4106 and 4128.

4. Part 208 is amended as set forth at the end of the common preamble.

**PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)**

5. The authority citation for part 225 continues to read as follows:

**Authority:** 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831i, 1831p–1, 1843(c)(8), 1844(b), 1972(1), 3106, 3108, 3310, 3331–3351, 3907, and 3909; 15 U.S.C. 1681s, 1681w, 6801 and 6805.

6. Part 225 is amended as set forth at the end of the common preamble.

**Federal Deposit Insurance Corporation  
12 CFR Chapter III**

**Authority and Issuance**

For the reasons set forth in the common preamble, the Federal Deposit Insurance Corporation proposes to further amend part 325 of chapter III of title 12 of Code of Federal Regulations, as proposed to be amended January 11, 2011, at 76 FR 1912 and 1921, as follows:

**PART 325—CAPITAL MAINTENANCE**

7. The authority citation for part 325 continues to read as follows:

**Authority:** 12 U.S.C. 1815(a), 1815(b), 1816, 1818(a), 1818(b), 1818(c), 1818(t), 1819 (Tenth), 1828(c), 1828(d), 1828(i), 1828(n),

1828(o), 1831o, 1835, 3907, 3909, 4808; Pub. L. 102–233, 105 Stat. 1761, 1789, 1790 (12 U.S.C. 1831n note); Pub. L. 102–242, 105 Stat. 2236, 2355, as amended by Pub. L. 103–325, 108 Stat. 2160, 2233 (12 U.S.C. 1828 note); Pub. L. 102–242, 105 Stat. 2236, 2386, as amended by Pub. L. 102–550, 106 Stat. 3672, 4089 (12 U.S.C. 1828 note).

8. Appendix C to part 325 is amended as set forth at the end of the common preamble.

Dated: December 7, 2011.

**John Walsh,**

*Acting Comptroller of the Currency.*

By order of the Board of Governors of the Federal Reserve System, dated: Dec. 7, 2011.

**Jennifer J. Johnson,**

*Secretary of the Board.*

By order of the Board of Directors.

Dated at Washington, DC, this 7th day of December 2011.

Federal Deposit Insurance Corporation.

**Robert E. Feldman,**

*Executive Secretary.*

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**BILLING CODE P**