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The Banking Agencies' New Regulatory Capital Proposals

June 2012

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On June 12, 2012 the Federal banking agencies (the Office of the Comptroller of the Currency, the Federal Reserve Board and the Federal Deposit Insurance Corporation) (the "Agencies") formally proposed for comment, in a series of three separate but related proposals (each a "Proposal, and collectively the "Proposals"), substantial revisions to the U.S. regulatory capital regimen for banking organizations that, if adopted, will have a significant impact on the entire U.S. banking industry.[1] Based on the core requirements of the 2011 international Basel III Accord ("Basel III"),[2] and in significant part on the "standardized approach" for the weighting and calculation of risk-based capital requirements under the 2004-2006 Basel II Accord ("Basel II"),[3] the Proposals will extend large parts of a regulatory capital regime that was originally intended only for large, internationally active banks to all U.S. banks and their holding companies, other than the smallest bank holding companies (generally, those with under $500 million in consolidated assets).

In addition, the Proposals incorporate aspects of Basel III that would apply only to those banking organizations that are subject to the "advanced approaches" or market risk rules under Basel II, including qualifying Federal and state savings associations and their holding companies. Under U.S. requirements, a banking organization is subject to the advanced approaches rules if it has consolidated assets greater than or equal to $250 billion, or if it has total consolidated on-balance sheet foreign exposures of at least $10 billion.[4] The market risk capital rule currently applies to any bank with aggregate trading assets and trading liabilities equal to 10 percent or more of total assets or at least $1 billion.

The Proposals do not address the global liquidity requirements that were also a part of Basel III. The Agencies have indicated, however, that they expect to propose rules implementing these requirements in the near future. In addition, the Proposals do not address the capital surcharge requirements applicable to systemically important financial institutions (banking organizations with consolidated assets of $50 billion or more) that are expected to be developed in the near future under section 165 of the Dodd-Frank Act.[5]

Comments on the Proposals are due by September 7, 2012.

Due to the scope and complexity of these Proposals, we expect to report separately on specific aspects of them, including their impact on financial instruments, derivatives activities, and securitization activities.

The Run-Up to the Current Proposals

In 2004, the Basel Committee published comprehensive revisions to the legacy 1988 Basel Capital Accord. Basel II retained the basic requirements of the legacy risk-based capital scheme, namely, a total capital to risk-weighted assets requirement of 8 percent, and the existing definitions of core and total capital. The new accord, however, significantly increased the risk sensitivity of assets held on the banking book, and created a framework for covered banking organizations to calculate their risk-based capital under one of two major approaches: the "standardized approach," which would require banking organizations to calculate their risk-based capital according to quantitative inputs provided by national banking supervisors; and the "internal ratings based" ("IRB") approach, under which covered banking organizations would calculate their risk-based capital requirements using a combination of external credit ratings and internal risk models that would be applied to general credit exposures and securitization exposures. In turn, the IRB approach was subdivided into the "foundation IRB approach" where banking organizations would rely primarily on external regulatory inputs for the key risk-based capital calculation components, and the "advanced IRB approach" where eligible banking organizations ("advanced approaches banking organizations") would calculate their risk-based capital requirements primarily based on internal risk models (approved for each banking organization by its national supervisor). Basel II was also configured as a "three pillar" framework requiring specific risk-based capital requirements for credit risk, market risk, and operational risk (Pillar 1), supervisory review of capital adequacy (Pillar 2), and market discipline through enhanced public disclosures (Pillar 3).

In the wake of the financial crisis that culminated in late 2008, the international banking supervisors, including the Agencies, concluded that the financial crisis revealed significant issues about the transparency, sufficiency and resilience of regulatory capital – both risk-based and leverage – that impaired the ability of banking organizations around the world to withstand financial shocks, which in turn contributed to the severity of the financial crisis. To address these concerns about the overall quality of regulatory capital, the Basel Committee undertook a review of the core components of regulatory capital, and in 2010 published Basel III, which was later revised in 2011. In addition, the Basel Committee made a number of changes to Basel II in 2009 and 2010 to address perceived shortcomings in the existing risk-weighting framework that were revealed by the financial crisis.

In contrast to Basel II, Basel III was entirely a product of the financial crisis. Basel III included a more restrictive definition of regulatory capital, higher minimum regulatory capital requirements, and capital conservation and countercyclical capital buffers, to better enable banking organizations to absorb losses and continue to operate as financial intermediaries during periods of financial and economic stress. Basel III also placed limits on banking organizations' capital distributions and certain discretionary bonuses if they did not hold specified "buffers" of common equity Tier 1 capital in excess of the new minimum capital requirements. More specifically, Basel III redefined the components of core (Tier 1) capital by subdividing Tier 1 capital into two components: (i) "common equity Tier 1" capital, consisting of common equity and equivalent capital instruments, plus retained earnings, and (ii) "Additional Tier 1" capital, consisting of capital instruments with features of common equity but which, in the Basel Committee's view, lacked the level of capital resilience presented by common tangible equity capital. In turn, Basel III created new quantitative requirements that would require affected banking organizations to maintain the preponderance of their Tier 1 capital in tangible common equity, and would increase the levels of Tier 1 and total risk-based capital that banking organizations would be required to hold.

In addition, Basel III proposed a general leverage capital requirement that previously had not been a part of the Basel regulatory capital framework. Moreover, to address concerns that banking organizations did not build up and maintain levels of regulatory capital that were adequate in times of financial stress, Basel III introduced a separate capital conservation buffer of up to 2.5 percent of total risk-weighted assets to consist of common equity Tier 1 capital, as well as a countercyclical buffer of potentially up to 2.5 percent of total risk-weighted assets to be implemented, on a national basis, through an extension of the capital conservation buffer/ratios and corresponding restrictions on capital distributions and discretionary compensation payments to employees.

Finally, to address perceived lapses in banking organizations' liquidity during the early stages of the financial crisis, as well as the failure of banking organizations to have in place liquidity and liquidity risk management practices adequate to assure the availability and proper management of liquidity in times of financial stress, Basel III introduced a twofold global liquidity standard. These liquidity requirements include (i) a liquidity coverage ratio to promote resilience to potential liquidity disruptions over a thirty-day horizon, and (ii) a net stable funding ratio that would require a minimum amount of stable sources of funding relative to the liquidity profiles of the assets, plus contingent liquidity needs arising from off-balance sheet commitments, over a one-year horizon.

Both Basel II and Basel III provided for extended transition periods in order to give affected banking organizations adequate time to develop and implement the required architectures and infrastructures. Basel II was to have been applied by covered banking organizations on a phased-in basis and fully effective for years after 2008. Implementation in the U.S., however, was substantially delayed until 2007, and was only in the early phases of implementation for U.S. banking organizations subject to the "advanced approaches" when the 2008 financial crisis overcame implementation efforts. Basel III provides for a transition period beginning in 2013 (2015, in the case of the required liquidity ratios), under which covered banking organizations are expected to comply with a series of gradually increasing risk-based and leverage capital measures, with full implementation generally expected by the end of 2018.

During the same period of time, the European Union has undertaken its own separate revisions to its regulatory capital rules. In July 2011, the EU Commission published a provisional draft of its much-awaited legislation in the form of a Capital Requirements Directive and Capital Requirements regulation (together known as CRD4), to implement Basel III into EU law.[6] The European Parliament and the Council of the EU are still considering the EU Commission's proposals, and have offered compromise proposals of their own. The Commission has stated its intention for CRD4 to become effective on January 1, 2013, and in line with the Basel Committee's expectations on the implementation timing for Basel III. The EU Commission has also stated that if other jurisdictions do not follow Basel III's implementation timetable, it will "draw all the necessary conclusions in due time." Whereas Basel II and Basel III focus only on internationally active banks, the existing Capital Requirements Directive in Europe currently applies to all European banks, as well as to European investment firms in general. The proposed CRD4 directive and regulation will retain this approach and will require corresponding adaptations of Basel III.

The Agencies' Proposals

Since the Basel III standards were published, the Agencies have been working to develop regulations to implement its requirements in the U.S. By its terms, Basel III applies only to large, internationally active banking organizations – in essence the same banking organizations that were subject to Basel II. At the same time, a continuing issue for the Agencies was the extent to which they believed it was necessary or appropriate to extend the Basel III elements beyond the large banking organizations to the broader banking industry.

The Proposals are a clear answer to this question: the Basel III Proposal, and much of the Standardized Approach Proposal, will apply to all U.S. banks and savings banks and almost all of their holding companies, although smaller, "non-complex" banking organizations will not need to comply with all of the Standardized Approach Proposal's requirements. Only the Advanced Approaches Proposal is limited in its applicability to the largest U.S. banks. Accordingly, U.S. banks that previously thought that Basel II and Basel III were academic exercises for them now are confronted with the challenge of coming up to speed on these aspects of the Proposals in a short period of time.

In addition, the Proposals are intended to complete a core regulatory capital directive of the Dodd-Frank Act, namely to delineate and apply to all U.S. banking organizations "generally applicable" capital requirements as directed by section 171 of the Dodd-Frank Act (the "Collins Amendment").[7] In this respect, the Agencies have stated plainly that the proposed regulations, if adopted, collectively will become the generally applicable capital requirements for purposes of the Dodd-Frank Act.

A. The Basel III Proposal

Applicability

The Basel III Proposal would apply to all U.S. banks that are subject to minimum capital requirements, including Federal and state savings banks, as well as to bank holding companies other than "small bank holding companies" (generally, bank holding companies with consolidated assets of less than $500 million).

General Elements of the Basel III Proposal

The Basel III Proposal, if adopted, would apply to U.S. banking organizations the general requirements for regulatory capital previously proposed in Basel III. In fact, with some exceptions, the Basel III Proposal closely tracks the requirements of its namesake Basel III. Specifically, the Basel III Proposal would do the following:

- It would revise the definition of regulatory capital components and related calculations, and would add a new regulatory capital component, namely, common equity Tier 1 capital.
- It would require a variety of new deductions from regulatory capital and impose new and substantial limitations on the treatment of qualifying minority interests as Tier 1 capital.
- It would increase the minimum Tier 1 capital ratio requirement.
- It would incorporate the new and revised regulatory capital requirements into the Agencies' respective Prompt Corrective Action ("PCA") capital categories.
- It would create a new capital conservation buffer framework that would limit payment of capital distributions and certain discretionary bonus payments to executive officers and their functional equivalents if the banking organization does not hold certain amounts of common equity Tier 1 capital in addition to those needed to meet its minimum risk-based capital requirements.
- It would provide for a series of transition periods for implementation of the proposed rule, including phase-in/phase-out periods for certain non-qualifying capital instruments, the new minimum capital ratio requirements, the capital

conservation buffer, and the regulatory capital adjustments and deductions. By 2019, the new capital requirements would be fully effective.

These changes would apply to all U.S. banking organizations, large and small (other than small bank holding companies). The changes, and some implications of these changes, are discussed below.

Revised Definitions and Calculations of Capital

A banking organization's Tier 1 capital would consist of its common equity Tier 1 capital and its additional Tier 1 capital. Total Tier 1 capital, plus Tier 2 capital, would make up the banking organization's total risk-based capital requirement.

Common equity Tier 1 capital would be the sum of its outstanding common equity Tier 1 capital instruments and related surplus (net of treasury stock), retained earnings, accumulated other comprehensive income ("AOCI"), and common equity Tier 1 minority interest, minus certain adjustments and deductions specified. In this regard, unrealized gains and losses on all available-for-sale securities held by the banking organization would flow through to common equity Tier 1 capital, a result that is not fully consistent with Basel III, which does not require common equity Tier 1 capital adjustments for unrealized gains and losses that are recognized on the balance sheet. Qualifying common equity Tier 1 capital would have to satisfy 13 criteria that are generally designed to assure that the capital is perpetual and is unconditionally available to absorb first losses on a going-concern basis, especially in times of financial stress (*see* Appendix A).

Additional Tier 1 capital would be the sum of additional Tier 1 capital instruments that satisfy 13 separate criteria (14 for advanced approaches banking organizations), related surplus, and Tier 1 minority interests that are not included in a banking organization's common equity Tier 1 capital, minus applicable regulatory adjustments and deductions. The 14 criteria in question generally are designed to assure that the instrument is available to absorb going-concern loss and does not possess credit sensitive or other terms that would impair its availability in times of financial stress (*see* Appendix A). Among other things, a banking organization that issues an additional Tier 1 capital instrument must limit capital distributions on the instrument to distributions that are paid out of net income and retained earnings, and must retain the ability to cancel dividends without triggering an event of default. The instrument must be perpetual in nature, have limited call rights that are exercisable only with the approval of the issuer's supervisory agency, must not have features that suggest or encourage redemption or discourage the issuance of additional capital instruments, and must be accounted as equity in accordance with generally accepted accounting principles ("GAAP").

Tier 2 capital of a banking organization similarly must satisfy 10 separate criteria (11 for advanced approaches banking organizations), all of which are designed to assure adequate subordination and stability of availability (*see* Appendix A). An advanced approaches banking organization may include the excess of eligible credit reserves over its total expected credit losses ("ECL") to the extent that such amount does not exceed 0.6 percent of its total credit risk-weighted assets.

The proposed criteria for common equity and additional Tier 1 capital instruments, and Tier 2 capital instruments, are broadly consistent with the Basel III criteria. One important consequence of these definitions is that non-cumulative perpetual preferred stock, which now qualifies as simple Tier 1 capital, would not qualify as common equity Tier 1 capital, but would qualify as additional Tier 1 capital. Further, cumulative preferred stock and trust preferred securities ("TruPS") no longer will qualify as Tier 1 capital of any kind.[8] In turn, banking organizations that have TruPS outstanding will need to evaluate and seek advice on whether the impact of the Basel III Proposal on outstanding TruPS will permit or require a call or redemption of their specific securities.

Moreover, other hybrid or other innovative capital instruments presumably will not satisfy the criteria for common equity Tier 1 capital, although some of these instruments might qualify as additional Tier 1 capital. In addition, minority interests in consolidated subsidiaries (discussed further below) would be subject to substantially stricter treatment than under the current capital rules. Certain capital instruments, however, such as those issued under the Emergency Economic Stabilization Act (e.g., TARP preferred securities) or the Small Business Jobs Act of 2010, would be grandfathered permanently from exclusion as Tier 1 capital instruments (a departure from Basel III and CRD4) and treated as additional Tier 1 capital.

The upshot of these new definitions will be to sharply reduce the capital instruments that are eligible for common equity Tier 1 capital treatment, which will make non-qualifying instruments ineligible for satisfaction of the new common equity Tier 1 capital ratio (discussed below). Some of these now-ineligible instruments may qualify for additional Tier 1 capital treatment, but they would not include instruments that are accounted for as liabilities under GAAP, inasmuch as one of the criteria for additional Tier 1 capital is that qualifying instruments must be accounted for as equity under GAAP – a financial reporting requirement on which Basel III (and CRD4 in Europe) is silent.

The Agencies believe that the impact of the new requirements on most perpetual non-cumulative preferred securities, and most Tier 2 debt instruments, should be modest, and therefore should be less of a compliance issue for affected banking organizations; whether this in fact proves to be the case, however, remains to be seen. At the same time, the Basel III Proposal suggests that the Agencies may be willing to consider the inclusion of new capital instruments – e.g., new contingent capital instruments – as additional Tier 1 capital, although it begs the question as to how much flexibility the Agencies have allowed themselves in this regard under the Basel III Proposal.

The Agencies also believe that the Basel III Proposal and U.S. law (including the requirements of the Dodd-Frank Act) are consistent with the Basel III non-viability standard, namely, that non-common stock capital instruments issued by a covered banking organization include terms that subject the instrument to write-off or conversion to common equity at the point at which the banking organization's supervisory authority determines that a write-off or conversion is required, or that governmental or public sector capital assistance would be needed to keep the banking organization solvent. For this reason, the Agencies have not proposed specific non-viability loss absorption (or "bail in") requirements or triggers, unlike the Basel Committee's recommendations and the proposed European capital regulations. Advanced approaches banking organizations, however, would have to disclose in the instrument's governing documentation that claims on such instruments may be fully subordinated to interests held by the U.S. government in the event of an insolvency or a similar proceeding.

Leverage Requirement. Consistent with Basel III, the Basel III Proposal sets forth separate leverage capital requirements, measured as a ratio of Tier 1 capital to average on-balance sheet assets, for affected banking organizations. Advanced approaches banking organizations would be subject to a new and separate supplementary leverage ratio, which according to the Agencies specifically is designed to implement the Basel III leverage ratio requirement. Under this requirement, these banking organizations would maintain capital not only against their on-balance-sheet assets (less amounts deducted from Tier 1 capital), but also certain off-balance sheet assets. Covered off-balance sheet exposures would include future exposure amounts arising under certain derivatives contracts, 10 percent of the notional amount of unconditionally cancellable commitments, and the notional amount of most other off-balance-sheet exposures (excluding securities lending and borrowing, reverse repurchase agreement transactions, and unconditionally cancellable commitments).

The leverage requirement does not create any new capital obligations for U.S. banking organizations, inasmuch as U.S. banks and their holding companies have long been subject to leverage capital requirements, although it does raise the general minimum leverage ratio for all banks (including the strongest banks) to 4 percent. The supplementary leverage ratio requirement that would apply to advanced approaches banking organizations, however, could in some instances have a meaningful impact on the amount of leverage capital that a large U.S. banking organization might be required to maintain, and arguably could decrease the attractiveness of such exposures for these banking organizations. At the same time, these requirements would not appear to be "written in stone," in that the Basel Committee has indicated that it intends to evaluate the Basel III leverage requirement through supervisory monitoring during a "parallel run" period, and presumably the Agencies would seek to coordinate their implementation efforts with the activities of their international counterparts.

Exclusions and Deductions from Capital

One of the significant aspects of the Basel III Proposal are the nature and scope of the exclusions and deductions from regulatory capital that would be required. Although the specific deductions again are broadly consistent with the requirements of Basel III, they would change in several important respects the current treatment of certain balance sheet items for regulatory capital purposes, especially for banking organizations that had expected (or hoped) that they would not be subject to Basel III.

The required exclusions and deductions would be:

- Deductions of goodwill and other intangibles from common equity Tier 1 capital, other than certain mortgage servicing assets.
- Deductions of carry-forward deferred tax assets, and nonrealizable carry-back deferred tax assets (subject to certain thresholds).
- Deductions from common equity Tier 1 capital of after-tax gain-on-sale associated with securitization exposures.
- Deductions from common equity Tier 1 capital of defined benefit pension fund assets other than those to which the banking organization has "unfettered access" (with supervisory approval).

- Deductions for Federal and state savings association subsidiaries engaged in activities that are impermissible for a national bank (note that this is not part of Basel III).
- Exclusion from common equity Tier 1 capital of unrealized gains and losses on certain cash flow hedges.
- Adjustments to common equity Tier 1 capital to reflect unrealized gains and losses resulting from changes in the banking organization's own creditworthiness.
- Deductions of *direct and indirect* investments in a banking organization's own regulatory capital instruments.
- Deductions of *direct, indirect and synthetic* investments in the capital instruments of unconsolidated "financial institutions" (a broadly defined term that is designed to capture any entity whose primary business is financial activities) where such investments exceed certain thresholds.
- Deductions of reciprocal cross-holdings in the capital instruments of financial institutions.

Investments in financial institutions are subdivided into "significant" (investments of more than 10 percent of the outstanding common shares or common share equivalents of the target entity) and "non-significant" investments (investments of 10 percent or less of the outstanding common shares and capital equivalents of the target entity). Significant common share investments would be deducted from common equity Tier 1 capital, subject to the deduction thresholds discussed below.

A potentially complicating aspect of the deductions for financial institution instruments is that the deduction applies to *indirect* (e.g., holdings through an equity index) and (in the case of financial institution investments) *synthetic* holdings, as well as direct holdings. This expansive application will pose a challenge to banking organizations that otherwise might elect to restructure their direct holdings into holdings that are not subject to deduction.

Significant unconsolidated financial institution common stock investments, non-realizable carry-back deferred tax assets, and mortgage servicing assets net of deferred tax liabilities would be deducted from common equity Tier 1 capital if they individually exceed a 10 percent common equity Tier 1 capital threshold (equal to 10 percent of common equity Tier 1 capital minus certain adjustments to and deductions from Tier 1 common equity). In addition, the sum total of the items that are not deducted under the 10 percent threshold could not exceed 15 percent of a banking organization's common equity Tier 1 capital, after applying all required regulatory adjustments and deductions to capital.

In calculating the deductions required for reciprocal cross-holdings of capital instruments, significant non-common stock financial institution investments, and non-significant financial institution investments, banking organizations would use the "corresponding deduction" approach, under which the banking organization is required to deduct an item from the same component of capital for which the instrument in question would qualify if it were issued by the banking organization itself.

Treatment of Minority Interests. Basel III reflects the general view of the international banking supervisors that minority interests – third party capital investments in a consolidated subsidiary of a banking organization – were not sufficient to absorb losses at the consolidated parent organization level. Basel III and the Basel III Proposal therefore limit the types and amounts of qualifying minority interests that can be included in Tier 1 capital.

Minority interests would be classified as a common equity Tier 1, Tier 1, or total capital minority interest depending on the underlying capital instrument and on the type of subsidiary issuing such instrument. In addition to meeting the eligibility criteria for common equity and additional Tier 1 capital, and Tier 2 capital (whichever is applicable under the circumstances), qualifying common equity Tier 1 minority interests would be limited to a depository institution or foreign bank that is a consolidated subsidiary of a banking organization. In addition, the limits on the amount of minority interest that may be included in the consolidated capital of a banking organization would be based on a formulaic amount of capital held by the consolidated subsidiary, relative to the amount of capital that the subsidiary would have to hold in order to avoid any restrictions on capital distributions and discretionary bonus payments under the capital conservation buffer framework discussed below.

Real estate investment trust (“REIT”) preferred shares, which up to now have qualified as Tier 1 capital of the banking organization, would not qualify for common equity Tier 1 capital treatment, but could qualify as additional Tier 1 or Tier 2 capital under the same general rules as are applicable to other qualifying minority interests. The REIT also would have to qualify as an operating entity that is set up to conduct business with the intention of earning a profit in its own right. In addition, since REITs must distribute 90 percent of their earnings in order to maintain their tax status, REITs would be required to have the ability to declare consent dividends (dividends that are declared but retained by the REIT) in order to qualify for additional Tier 1 capital treatment.

Minimum Capital Requirements

The Basel III Proposal would require that banking organizations satisfy the following minimum capital ratios: (i) a common equity Tier 1 capital ratio of 4.5 percent; (ii) a Tier 1 capital ratio of 6 percent; (iii) a total capital ratio of 8 percent; and (iv) a Tier 1 capital to average consolidated assets of 4 percent and, for advanced approaches banking organizations only, an additional leverage ratio of Tier 1 capital to total leverage exposure of 3 percent. As noted above, the common equity Tier 1 capital ratio would be a new minimum requirement. As discussed below, these capital levels would be phased in over a multi-year period beginning in 2013 and ending in 2018.

Capital Conservation Buffer

Consistent with Basel III, the Basel III Proposal would create a capital conservation buffer for all covered banking organizations that would be phased in starting in 2016, and would require additional regulatory capital of 2.5 percent on a fully phased-in basis by January 1, 2019. The capital conservation buffer would be applied to the lowest of the following three ratios: the banking organization’s common equity Tier 1, its Tier 1 and total capital ratio less its minimum common equity Tier 1, or its Tier 1 and total capital ratio requirement, respectively. Besides being designed to bolster the resilience of banking organizations throughout financial cycles, one primary purpose of the capital conservation buffer is to limit the ability of a banking organization to make capital distributions and discretionary bonus payments to executive officers and persons with commensurate responsibilities unless the banking organization has sufficient capital over and above its minimum capital requirements to safely make those payments.

Under the Basel III Proposal, a "capital distribution" means: (i) a reduction of Tier 1 capital (by repurchase or otherwise); (ii) a reduction of Tier 2 capital (by repurchase or early redemption or otherwise); (iii) a dividend on Tier 1 capital; (iv) a dividend or interest payment on Tier 2 (where the banking organization has discretion to suspend that payment); and (v) any substantively similar transaction. In turn, a "discretionary bonus payment" to an executive officer (generally defined as a titled executive or person with commensurate executive responsibilities) is any payment where (i) the banking organization retains discretion as to whether to pay or the amount of payment, (ii) the amount paid is determined without prior promise to, or agreement with, the officer, and (iii) the executive officer has no contractual right to the payment. Depending on the extent to which a banking organization met its capital conservation buffer requirements, capital distributions and bonus payouts would be limited to specified payout ratios.

Banking organizations that are not subject to the Basel II advanced approaches rule would calculate their capital conservation buffer using total risk-weighted assets as calculated by all banking organizations, and banking organizations subject to the advanced approaches rule would calculate the buffer using advanced approaches total risk-weighted assets. The principle behind this distinction is that internationally active U.S. banking organizations using the advanced approaches would be expected to maintain capital conservation buffers comparable to those of their foreign competitors.

Countercyclical Capital Buffer

The countercyclical capital buffer, which is a supplemental capital requirement that is designed to take into account the macro-financial environment in which large banking organizations operate, would be applied *only* to advanced approaches banking organizations, consistent with the requirements of Basel III. On a fully phased-in basis, the countercyclical capital buffer would be additional regulatory capital of up to 2.5 percent of total risk-weighted assets. The countercyclical capital buffer would augment the capital conservation buffer upon a joint determination by the Agencies. The countercyclical capital buffer amount in the U.S. would initially be set at zero, but would increase if the Agencies determined that there is excessive credit in the markets, possibly leading to subsequent widespread market failures. The Agencies expect to consider a range of macroeconomic, financial, and supervisory information indicating an increase in systemic risk. Because the countercyclical capital buffer amount would be linked to the condition of the overall U.S. financial system and not the characteristics of an individual banking organization, the Agencies propose to apply the countercyclical capital buffer amount consistently at the depository institution and holding company levels.

Changes to Prompt Corrective Action Rules

Although not required by Basel III itself, the Basel III Proposal would amend the Agencies' PCA regulations under section 38 of the Federal Deposit Insurance Act to assure consistency with the new regulatory capital requirements. Specifically, the Agencies propose to:

- augment the existing five PCA capital categories (well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized) by introducing the common equity Tier 1 capital measure for four of the five PCA categories (excluding the critically undercapitalized PCA category); and
- for advanced approaches banking organizations, include in the leverage measure for the "adequately capitalized" and "undercapitalized" capital categories an additional leverage ratio based on the leverage ratio in Basel III.

All banking organizations would continue to be subject to leverage measure thresholds using the current "standard" leverage ratio of Tier 1 capital to total assets. Further, the Agencies would revise the three current capital measures for the five PCA categories to reflect the changes to the definition of capital, as provided in the proposed revisions to the agencies' PCA regulations.[9]

Transitional Periods

The Basel III Proposal provides for a series of transitional and phase-in provisions for the new capital rules. According to the Agencies, they are intended to give banking organizations adequate time to comply with the new capital requirements and also be compliant with the Dodd-Frank Act. Almost all of the requirements proposals under the Basel III proposal would be fully effective by January 1, 2019. In general, the transition provisions are as follows:

Phase-in of Minimum Capital Ratios. The minimum common equity and Tier 1 capital ratios would be phased in beginning in the 2013 calendar year with a common equity requirement of 3.5 percent and a Tier 1 requirement of 4.5 percent for that year; 4.0 percent and 5.5 percent, respectively, for the 2014 calendar year; and fully effective (4.5 percent and 6.0 percent, respectively) for the 2015 calendar year and thereafter.

Phase-in of Regulatory Capital Adjustments and Deductions. The required regulatory capital adjustments and deductions will be phased in beginning in 2013 and fully phased in by 2018. The phase-in sequence consists of a series of formulae that would apply different phase-in requirements and transitional capital treatment of adjusted or non-qualifying items according to the specific nature of the item. For example, the transition method for several capital deduction items (such as deferred tax assets, securitization gain-on-sales, and defined benefit pension fund assets) is a straight-line percentage deduction sequence (0 percent of required deductions in 2013, 20 percent of required deductions in 2014, and so forth) that requires full (100 percent) deductions in the calendar year 2018. Deductions for goodwill from common equity Tier 1 capital, however, are subject to no transitional phase-in and must be fully deducted beginning in the calendar year 2013.

Phase-out of Non-qualifying Capital Instruments. The phase-out transition period for these instruments begins in the calendar year 2013. The exact phase-out period, however, is different for banking organizations with at least $15 billion in total assets than it is for banking organizations under that threshold. For the larger banking organizations, the transition method for nonqualifying capital instruments is a straight-line percentage inclusion sequence (75 percent of non-qualifying instruments may be included in Tier 1 or Tier 2 capital in 2013, 50 percent may be included in 2014, and so forth), with full effectiveness in 2016. For banking organizations with under $15 billion in total assets, the transition period begins (again on a straight-line basis) in 2013 but is not fully phased in until 2022.

Phase-in of Capital Conservation and Countercyclical Capital Buffers. The capital buffer requirements become fully effective on January 1, 2019. Each of the two buffers would be established at 0.625 percent in 2016 and then phased in on a straight-line basis up to 2.5 percent in 2019 and thereafter. Banking organizations should keep in mind that these phase-in requirements must be attained in order to avoid restrictions on capital distributions and discretionary payouts during the transition period.

Supplemental Leverage Ratio. Advanced approaches banking organizations would not be required to apply the supplemental leverage ratio until 2018. These banking organizations, however, would be required to calculate and report (but not comply with) using the advanced approaches definitions of Tier 1 capital and total exposure measure beginning in 2015.

Prompt Corrective Action. The conforming changes to the Agencies' PCA regulations would be effective on January 1, 2015, although the proposed amendments to the current PCA leverage measure for advanced approaches banking organizations would be effective on January 1, 2018.

One of the complicating aspects of these transition periods is that a banking organization will have to incorporate and harmonize different phase-in and phase-out timelines and specifications. Because there are different transition requirements for different capital ratios (risk-based, leverage and capital buffers), as well as for divergent types of regulatory deductions and nonqualifying capital instruments, the calculation of Tier 1 and Tier 2 capital requirements during these transition periods will have to be carefully structured and executed.

B. The Standardized Approach Proposal

The Standardized Approach Proposal is the result of two distinct regulatory impulses. In large measure, the Standardized Approach Proposal responds to many of the asset quality problems that emerged during the financial crisis and that were not satisfactorily addressed by the regulatory capital rules. The Standardized Approach Proposal introduces more rigorous and more calibrated capital measurements in an effort to encourage prudent lending and other banking business and to discourage those activities thought to have contributed to the crisis. The Standardized Approach Proposal also represents the continuation of the Agencies' efforts, begun even before the financial crisis, to develop more sensitive but still manageable measurements of credit risk and capital adequacy by all banks other than the largest and most internationally active banks.

Applicability

The rules set forth in the Standardized Approach Proposal would formally apply to the same universe of banking and thrift institutions that is subject to the Basel III Proposal.[10] Various parts of the Standardized Approach Proposal, however, would have different effects on different types of banking organizations. The Standardized Approach

Proposal includes an Addendum 1, which highlights issues that are likely to be of greatest interest to community banks, namely, those with less than $10 billion in consolidated assets. The preamble to the Standardized Approach Proposal conversely identifies those provisions likely to have little effect on community banks. Neither discussion purports to be exhaustive. The only provisions specifically not applicable to community banks are certain disclosure requirements that would apply only to banking firms with more than $50 billion in consolidated assets.

The Standardized Approach Proposal applies even to the largest U.S. banking organizations that use the advanced approaches under Basel II. As discussed above, the Collins Amendment to the Dodd-Frank Act sets a floor to the capital requirements for these organizations, and the Standardized Approach would be this floor.

Effective Date

The proposal, if finalized, will take effect on January 1, 2015. Banks have the option to adopt the rules earlier. Unlike the Basel III Proposal, the Standardized Approach Proposal does not provide for any transition period. The same residential mortgage loan that was weighted at 50 percent in the fourth quarter of 2014 could, for example, be risk-weighted at 75 percent in the first quarter of 2015—an abrupt 50 percent increase in the capital charge.

General Elements of the Standardized Approach Proposal

The Standardized Approach Proposal revises a large number, although not quite all, of the risk weights (or their methodologies) for bank assets. The overall financial impact may or may not be substantial for a bank, but the changes will require virtually every bank covered by the proposal to review the capital charges for its asset classes across the board. For nearly every class, the Standardized Approach Proposal requires a more calibrated assessment of credit risk. As a result, a bank's capital planning process will require more information about many asset classes than is necessary to satisfy the existing capital rules.

The Standardized Approach Proposal changes the existing risk weights and the underlying methodologies in numerous ways. For ease of analysis, we have somewhat arbitrarily distinguished between the weighting of traditional loans and extensions of credit and the assessment of risk weights for other transactions that expose a bank to the credit risk of a counterparty. The changes are, in summary, as follows:

Traditional Loans and Extensions of Credit

- Traditional residential mortgage loans will receive somewhat more advantageous capital treatment than the more complex loans that proved so problematic in the financial crisis. Loan-to-value ratios are critical, though, and only traditional mortgage loans with an LTV ratio of 80 percent or less will avoid a higher risk weight under the Standardized Approach Proposal. The risk weights for mortgage loan guarantees generally have not changed, which may soften the blow of these higher risk weights.
- Commercial real estate loans would require greater economic participation by developers or other borrowers. In the absence of such participation, the risk weight on a loan would increase by 50 percent.

- Corporate exposures generally are assigned a risk weight of 100 percent.
- Past-due commercial loans (more than 90 days past due or on non-accrual status) will be risk-weighted at 150 percent.
- Off-balance sheet items will be subject to certain changes, including a new minimum 20 percent conversion factor for many short-term commitments and a new measurement of the counterparty credit risk of a repo-style transaction.
- Foreign sovereign debt, as well as the debt of public sector entities ("PSEs") and banks domiciled in the country, would be risk-weighted based primarily on the country risk classification assigned by the Organisation for Economic Co-operation and Development ("OECD").[11] The existing risk weights are a function largely of whether a country is or is not an OECD member.

Other Transactions Involving Credit Risk

- Over-the-counter derivative contracts ("OTC derivatives") would no longer be able to take advantage of a 50 percent risk weight cap. The Standardized Approach Proposal also will adjust the measurement of the exposure of an OTC derivative.
- Transactions cleared through CCPs will receive more favorable treatment than transactions conducted over the counter, although the extent of the advantage would depend on the nature of the CCP.
- Guarantees and collateral will receive mixed treatment. The scope of eligible guarantors will widen, and more types of collateral will be permitted, but the Standardized Approach Proposal places new limits on their terms.
- Securitization exposures would be weighted according to either the current gross-up method or a new formula to replace the existing method that is based on credit ratings. The proposal also imposes new qualitative requirements, including a bank's demonstration of its understanding of the nature and risks of its securitization exposures.

The Standardized Approach Proposal also addresses two issues not directly related to credit risk:

- Equity exposures would receive new risk weights, distinguishing between equity exposures generally and equity exposures to investment companies.
- Disclosure requirements relating to regulatory capital will apply to banks with total consolidated assets of $50 billion or more and that are not subject to the disclosure requirements under the advanced approaches capital rule.

All of these changes will affect capital planning. Efforts to maximize capital efficiency for a particular asset class will depend on the nature of the change. There are at least four general possibilities.

- For some products, modest adjustments may result in noticeably better capital treatment. For example, for some short-term unfunded commitments, a bank may be able to insist on an unconditional right to cancel, thus avoiding a 20 percent conversion factor (and resulting capital charge) for the commitment. Additionally, to the extent that a bank can clear a derivative transaction through a CCP rather than trade it over the counter, it will realize significant capital benefits.

- For other products, the Standardized Approach Proposal imposes new and punitive capital charges that presumably will force banks to change their handling of the products. As one example, in commercial real estate lending, a bank must require greater economic participation by a borrower in a project or otherwise face a risk weight that is 50 percent higher than the current risk weight. For securitization exposures, the proposal effectively compels a bank to demonstrate its understanding of and ability to manage the risks of each type of exposure. If the bank cannot do so, it must hold capital on a dollar-for-dollar basis (a 1,250 percent risk weight) against the exposure.

- In some cases, the increased capital charges will be unavoidable and present a bank with a choice of whether to continue a particular line of business. The higher risk weights for mortgage loans that are either nontraditional or have LTV ratios aboe 80 percent may cause a bank to consider whether to offer such loans.

- In nearly all cases, a bank should bear in mind that the Standardized Approach Proposal expands the universe of guarantors capable of providing risk-mitigating guarantees, including private sector entities with strong credit ratins and that meet other criteria.

Several of these changes warrant further discussion. We consider the risk-weighting changes with respect to residential mortgage loans, commercial lending, OTC derivatives, cleared transactions, guarantees and credit derivatives, collateralized transactions, unsettled transactions, securitization exposures, equity exposures, and sovereign debt and foreign bank exposures.

Residential Mortgages

Originations and Loans Held in Portfolio. The Standardized Approach Proposal provides greater incentives for banks to engage in what is commonly regarded as traditional mortgage lending. It creates two categories of mortgage lending. Traditional lending constitutes category 1, where the risk weights range from 35 to 100 percent. Other, nontraditional types of loans fall within category 2, where the risk weights range from 50 to 150 percent.

In order to qualify for category 1 treatment, the lending bank or the terms of the loan will be required to satisfy eight sets of prerequisites:

- Duration of the loan does not exceed 30 years.
- The terms of the loan provide for regular periodic payments. A loan is ineligible for category 1 if the loan payments would either:
    - Result in an increase in the principal balance—i.e., loans with a negative amortization feature.
    - Allow deferral on the repayment of principal. Payment option adjustable rate mortgage loans thus are outside Category 1.

    - Result in a balloon payment.
- Underwriting standards must:
    - Take into account all of the borrower's obligations, including mortgage obligations, principal, interest, taxes, insurance (including mortgage guarantee insurance), and assessments.
    - Result in a conclusion that the borrower is able to repay the exposure using the maximum interest rate that may apply during the first five years after closing of the loan. The amount of the exposure is the maximum possible contractual exposure over the life of the mortgages as of the date of closing.
- For adjustable rate mortgages, the rate may adjust no more than two percentage points in any twelve month period and no more than six percentage points over the life of the loan.
- For a first-lien home equity line of credit ("HELOC"), the borrower must be qualified using the principal and interest payments based on the maximum contractual exposure under the terms of the HELOC.
- Income must be documented and verified.
- The bank must hold the first-lien mortgage.
- If the bank has secured its credit exposure with both first lien and junior liens and if there is no intervening lien holder, then the full exposure must have all of the characteristics of a category 1 loan.

The Standardized Approach Proposal also imposes a continuing requirement. If, at any time after the loan has closed, the loan is 90 days or more past due or is on non-accrual status, it is re-assigned to category 2. The existing capital rules do not change the risk-weighting of a mortgage loan that become past due.

Risk weights within each category are a function of a loan's LTV ratio. The net effect of the changes in the proposal is that all but the most conservative and traditional mortgage loans will be subject to higher risk weights. In category 1, a loan with an LTV above 80 percent—the traditional threshold for conforming loans—will require greater capital than under the current rules. If the LTV is 60 percent or less, the loan is weighted at 35 percent. For loans with LTVs of more than 60 percent and equal to or below 80 percent, the risk weight is 50 percent. If the LTV is more than 80 percent and equal to or below 90 percent, the weight is 75 percent. All category 1 loans with LTVs above 90 percent are risk-weighted at 100 percent

A mortgage loan that does not qualify for category 1 automatically falls within category 2, where the risk weights are at least twice the weights as those under the existing capital rules. A Category 2 loan with an LTV of 80 percent or less is risk-weighted at 100 percent. Loans with LTVs equal to or below 90 percent are risk-weighted at 150 percent. Loans above the 90 percent level must be risk-weighted at 200 percent.[12]

The Standardized Approach Proposal eliminates some of the benefits of private mortgage insurance ("PMI"). The current capital rules permit a bank to apply the amount of PMI against the amount of the loan for the purpose of calculating the LTV ratio. The Proposal does not allow this practice.

Guaranteed Mortgage Loans. For mortgage loans guaranteed by the U.S. government or one of its agencies, the risk weights have not changed. Loans unconditionally guaranteed by the U.S. government or one of its agencies carry a zero percent risk weight; conditionally guaranteed loans are weighted at 20 percent. The government entities capable of providing this type of guarantee include the Veterans Administration, the Federal Housing Administration, and Ginnie Mae. Loan guarantees by Fannie Mae and Freddie Mac continue to be risk-weighted at 20 percent.

Restructured Loans. The Standardized Approach Proposal gives somewhat more favorable treatment to the restructuring or modification of residential mortgage loans than do the existing capital rules. Currently, a restructured or modified mortgage loan must be risk-weighted at 100 percent, regardless of the features of the restructured or modified loan. Recognizing that restructuring or modification may reduce credit risk, rather than signal increased credit risk, banks will be able to look to the terms of a restructured or modified loan in order to assign the appropriate risk weight. Such a loan will be assigned to category 1 if the revised terms of the loan meet the category 1 conditions that apply to newly originated loans; otherwise, the loan will be placed in category 2. The presumptive risk weights in the two categories are 100 and 200 percent, respectively. A bank may apply the lower risk weights for similar newly originated loans if the bank has updated the LTV ratio at the time of the restructuring.

Loans modified pursuant to the Home Affordable Mortgage Program ("HAMP") receive even more favorable treatment. Such loans will not be treated as restructured or modified loans and will continue to carry the same risk weight as before the modification.

Secondary Market. The treatment of securitization exposures under the Standardized Approach Proposal is covered in greater detail below, but banking organizations should focus on one change referenced above under the Basel III Proposal: the originator may be required to deduct gains on the sale of mortgage loans from common equity tier 1 capital. This deduction may bring an end to the originate-to-sell practices that some mortgage lenders had adopted before the financial crisis, although this business model already has fallen into disuse.

Commercial Lending

Residential Construction and Multifamily Loans. The current risk-based capital rules assign a risk weight of 50 percent to certain one-to-four family residential presold construction loans and to multifamily loans. A 100 percent risk weight applies to a presold construction loan if the purchase contract is cancelled. These risk weights are fixed by statute and cannot be changed. The Standardized Approach Proposal, however, adds several new conditions to both kinds of loans in order to qualify for these risk weights.

Presold construction loans must meet several prerequisites designed to ensure that the property will in fact be sold on completion. Two notable new requirements are, first, that the builder incur at least the first 10 percent of the direct costs of construction (land, labor, and constsruction) before the builder may begin to draw down on the loan; and, second, that the loan amount may not exceed 80 percent of the sales price of the presold residence.

Loans secured by mortgages on multifamily properties will remain eligible for the 50 percent risk weight if several conditions are met. For example, a newly originated multifamily loan cannot be risk-weighted at 50 percent and must be weighted at 100 percent. If, after at least one year, the borrower has made all principal and interest payments on time, the loan will be eligible for the 50 percent risk weight, if other conditions are satisfied. These conditions include the following: (i) the LTV ratio does not exceed 80 percent on a fixed rate loan or 75 percent on a loan where the rate may adjust; (ii) amortization of principal and interest must occur over a period of not more than 30 years, and the original maturity for repayment of principal is not less than seven years; and (iii) annual net operating income of the property must exceed annual debt service by 20 percent for a fixed-rate loan or 15 percent for a loan where the rate may vary.

Commercial Real Estate. Most commercial loans will continue to be risk-weighted at 100 percent. The one significant change is for "high volatility" commercial real estate loans ("HVCRE loans"), a subset of ADC loans. HVCRE loans will be risk-weighted at 150 percent. A lender may be able to return an ADC loan to the 100 percent risk weight through underwriting and the imposition of certain terms, as follows:

- The LTV ratio is less than or equal to the "applicable maximum supervisory LTV ratio."
- The borrower has contributed at least 15 percent of the appraised "as completed" value of the property. The contribution may take the form of cash or unencumbered readily marketable assets, or the borrower may have paid development expenses out of pocket.
- The borrower has paid to the bank the capital charge that the bank will have to incur on the loan and has done so before the bank advances any funds. The contributed capital, which may eventually include capital generated internally by the project, must remain in place until the project is completed, the facility converts to permanent financing, or is sold or paid in full. Permanent financing by the bank must conform to the bank's underwriting criteria for long-term commercial mortgage loans.

An ADC loan to finance one- to four-family residential properties, however, may continue to be risk-weighted at 100 percent.

Unfunded Commitments. A greater number of unfunded commitments will carry a capital charge than under the existing capital rules. Unfunded commitments currently have no capital charge (technically, they are converted to an on-balance sheet asset at zero percent) in either of two circumstances: (i) the original maturity of the commitment is one year or less; or (ii) the bank may unconditionally cancel the obligation and has the contractual right (which it exercises) to make a separate credit decision before each drawing or an annual credit review to determine whether to continue the facility.

Under the Standardized Approach Proposal, only those commitments that are unconditionally cancelable by the bank are eligible for the zero percent conversion factor. Unfunded commitments with an original maturity of one year or less must be converted onto the balance sheet at 20 percent. The 50 percent credit conversion factor that has been in effect for unfunded commitments with an original maturity of more than one year and that are not unconditionally cancelable by the bank will remain in effect.

Over-the-Counter Derivatives

Under the Standardized Approach Proposal, the capital requirements for OTC derivatives contracts are fairly complex, in connection with both risk weighting and the determination of the exposure to be risk-weighted. We will discuss these requirements in greater detail in a forthcoming advisory.

The risk weights will differ for equity and credit derivatives. Equity derivatives may be treated as forms of equity exposure and will be risk-weighted according to those rules. Alternatively, for an advanced-approaches bank, the bank might treat an equity derivative as a covered transaction under the proposed market risk capital rules, in which case the derivative will be treated in accordance with the requirements for counterparty credit risks. Credit derivatives may be risk-weighted in different ways as well. If the derivative is eligible to serve as a credit risk mitigant, then it will be weighted as such (see the discussion of guarantees and credit derivatives below). A credit derivative might also be regarded as presenting a counterparty credit risk, and credit risk might also reside in the underlying reference asset.

As to the amount of the exposure to be risk-weighted, that amount depends primarily on whether the derivative is subject to a master netting agreement.

- If the derivative is not subject to a master netting agreement, then its exposure is the sum of the current credit exposure and the potential future exposure ("PFE"). While the calculation of the PFE is complex, it cannot exceed the present value of the unpaid premiums on the contract.
- For multiple OTC derivatives that are subject to a "qualifying" master netting agreement, the collective risk weight for all derivatives covered by the same agreement is the sum of the current net credit exposure and the adjusted sum of the PFE. The agreement is "qualifying" if it meets certain criteria relating to a bank's ability to accelerate, terminate, or close out all transactions in the event of a default and to the continuing enforceability of the agreement in the event of a legal challenge, including one arising out of a bankruptcy or insolvency proceeding.

Cleared Transactions

New risk-weighting methodologies will apply to two types of "cleared transactions" derivatives contracts and repo-style transactions that a bank has entered into with a CCP. The appropriate methodologies depend on three variables: whether the CCP is "qualifying,", whether the bank is a clearing member of the CCP or a client of a CCP clearing member, and whether the cleared transaction is a derivatives transaction or a repo-style transaction. In all cases, a bank must first determine the amount of the transaction to be risk-weighted, known as the "trade exposure," and then determine the appropriate risk weight.

Where the bank is a CCP clearing member, the trade exposure of a derivatives transaction is the exposure amount calculated in the same way as the exposure amount of an OTC derivative; the trade exposure of a repo-style transaction is calculated in the same way that the bank would calculate the exposure for the purpose of determining the value of collateral securing the exposure under the "collateral haircut approach" for collateralized transactions. In either case, if the CCP holds collateral from the bank in a manner that is not bankruptcy remote, the fair value of the collateral is added to the trade exposure amount for risk-weighting purposes. Once the trade exposure is set, it will be risk-weighted at two percent if the CCP is qualifying. If the CCP is not qualifying, then the risk weight is determined in accordance tihe the general capital risk weights in the Standard Approach Proposal. The weight accordingly may vary but presumably could be as high as 100 percent.

If the bank is a client of a CCP member, the different trade exposures are calculated in the same manner as by banks that are CCP members. If the CCP is qualifying, then the bank may risk-weight its exposure at two percent, if the collateral that the bank has posted with the CCP in connection with the transaction is protected from any losses that could arise from the default or insolvency of the CCP member or any of its other clients.[13] If the collateral is not so protected, then the bank must weight the exposure at four percent. If the CCP is not qualifying, then the risk weight is the same risk weight for any exposure to the CCP.

In order for a CCP to "qualify," the CCP must satisfy certain conditions and receive agency approval. Precisely how the regulators will handle the approval process is unclear, since the conditions are specific to the CCP but not to its members, and presumably the regulators' first approvals would cover all later banks (unless there is some change to the CCP). In order to qualify, the CCP must be a "designated" financial market utility under Title VIII of the Dodd-Frank Act[14] (or, if outside the United States, be subject to comparable regulation), must require that all contracts cleared by it are fully collateralized on a daily basis, and must provide certain capital information to the bank, the bank's regulator, and the CCP's regulator. The bank also must demonstrate that the CCP is in sound financial condition, is supervised by the Federal Reserve Board, the Commodity Futures Trading Commission ("CFTC"), or the Securities and Exchange Commission ("SEC"), and meets or exceeds the risk management standards established by the Federal Reserve Board, the CFTC, or the SEC. CCPs located outside the United States may qualify if the home-country standards are functionally equivalent to U.S. standards.

Guarantees and Credit Derivatives

The Standardized Proposal's treatment of credit enhancement—guarantees, credit derivatives and collateral (discussed further below)—is complex. On the one hand, the Standardized Approach Proposal recognizes a wider range of guarantors and more types of collateral. On the other hand, it imposes additional conditions on the use of these enhancements.

Guarantees. The existing capital rules generally require no capital to the extent that an asset is guaranteed by the U.S. government and its agencies or by the central government of an OECD country. In certain circumstances, these rules also recognize guarantees from central governments of non-OECD countries. Guarantees by banks organized in OECD countries require only a 20 percent risk weight, as do guarantees from Fannie Mae and Freddie Mac, and guarantees from multilateral lending institutions or regional development institutions in which the United States is a shareholder or contributing member.

The Standardized Approach Proposal enlarges the set of eligible guarantors to include any sovereign, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, a Federal Home Loan Bank, Farmer Mac, a multilateral development bank, a depository institution, a bank holding company, a savings and loan holding company, a credit union, and a foreign bank.

Also eligible to issue valid guarantees are third-party private sector entities that meet three conditions: (i) they have issued and outstanding unsecured debt securities without credit enhancement that are investment grade; (ii) their creditworthiness is not positively correlated with the credit risk of the exposures for which they are providing protection; and (iii) they are not insurance companies predominately engaged in the business of providing credit protection.

A guarantee provided by these guarantors must satisfy several requirements designed to ensure that the guarantee is unconditional (there is one limited exception for certain conditional guarantees by the U.S. government), readily accessible, and enforceable. An affiliate cannot provide a valid guarantee.

Credit derivatives. The proposal also recognizes the risk mitigation that may be provided by certain credit derivatives: credit default swaps, nth-to-default swaps, total return swaps, or other swaps approved by a bank's primary federal supervisor. These swaps must meet the same eligibility requirements as a guarantee as well as other conditions to confirm that the swap will provide the protection when needed.

Protection. Determining the precise protection amount provided by the guarantee or credit derivative may be a complicated undertaking. As a starting point, the amount is the effective notional amount: the lesser of the contractual notional amount or the exposure amount of the credit to be protected, multiplied by the percentage coverage of the credit risk mitigant. This amount then must be adjusted to take into account any maturity mismatches, lack of restructuring coverage, currency mismatches, and multiple credit risk mitigants..

Collateralized Transactions

The Standardized Approach Proposal would recognize only "financial collateral" as having a risk-mitigating effect. This collateral consists of cash on deposit, gold bullion, long-term debt securities that are not resecuritization exposures and that are investment grade, short-term debt instruments with the same characteristics, publicly-traded equity securities and convertible bonds, money market fund shares, and other mutual fund shares with a publicly-quoted daily price. Financial collateral has a risk-mitigating effect only if a bank has a perfected, first-priority interest in it. Collateral held outside the U.S. also may qualify if the bank has the equivalent of a perfected, first-priority interest.

The Standardized Approach Proposal offers two options for recognizing the risk-mitigating effect of financial collateral: a "simple approach" and a "collateralized haircut approach." As a practical matter, the latter approach is a meaningful possibility only for complex banks; it requires sophisticated mathematics to determine the ultimate effect. However, the collateralized haircut approach must be used for collateral securing certain exposures described below.

Community banks likely will rely on the simple approach (with the proviso for certain exposures above). The principal disadvantage of the simple approach is that, while there is no haircut on the collateral, the risk weight for a collateralized exposure must be at least 20 percent, regardless of the risk weight of the collateral on a stand-alone basis. This rule may discourage the use as collateral of items otherwise risk-weighted at zero percent, including cash on deposit and gold. The 20 percent floor does not apply to certain collateral for OTC derivatives. If the collateral is cash on deposit, there is no floor, and the exposure may be risk-weighted at zero percent. If it is sovereign debt (which otherwise has a zero percent risk weight), the exposure may be risk-weighted at 10 percent.

Under the simple approach, financial collateral has a risk-mitigating effect if a bank satisfies three conditions: (i) the bank has entered into a written agreement for the life of the loan or other exposure; (ii) the bank revalues the collateral every six months; and (iii) the collateral is designated in the same currency. Once these requirements are met, the bank may use the market value of the collateral to replace the same value in the exposure. If the collateral value covers the entire exposure, the risk weight of the collateral will apply. If the collateral covers the exposure in part, then the exposure will be risk-weighted on a pro rata basis.

With respect to the collateralized haircut approach, collateral securing "eligible" margin loans, repo-style transactions,[15] collateralized derivatives contracts, and the single-product netting of such transactions will be haircut both for market price volatility and currency mismatches. The volatility haircuts will vary considerably, from 0.5 percent to 25 percent, depending on the issuer and the residual maturity of the collateral. For collateral securing repo-style transactions, the haircuts are approximately 30 percent less than the haircuts on the same collateral for other transactions. There is a standard eight percent haircut when collateral is a different currency than the underlying exposure. A bank may seek agency approval to use its own internal haircuts, but the bank must submit considerable documentation to support the validity of those haircuts.

Unsettled Transactions

Among the new provisions in the Standardized Approach Proposal are graduated capital requirements for transactions that have not settled on time. The new requirements apply to transactions involving the delivery of securities or commodities (known as delivery-versus-payment or DvP transactions) or the payment of foreign exchange instruments (known as payment-versus-payment or PvP transactions). Different requirements apply where a bank already has performed and is waiting for the return performance—a circumstance known as a non-DvP/non-PvP transaction.

The new requirements do not apply to cleared transactions that are marked to market daily and are subject to daily receipt and payment of variation margin, repo-style transactions, one-way cash payments on OTC derivative contracts, and transactions with a contractual settlement date that is longer than five business days after the market standard. These exempt transactions are generally subject to capital requirements related to OTC derivatives transactions.

For DvP and PvP transactions, capital requirements take effect if the transaction has not settled within five business days. The amount to be risk-weighted is the "positive current exposure" of the bank: the difference between the transaction value at the agreed settlement price and the current market price of the transaction. Capital is required if the market price has moved against the bank. The risk weights increase as settlement continues to be delayed. The proposal provides a grace period of only four days, and after 45 days, the bank must hold capital on its credit risk exposure on nearly a dollar-for-dollar basis. The weights are as follows:

Number of days after the settlement date	Risk weight
From 5 to 15	100 percent
From 16 to 30	625 percent
From 31 to 45	937.5 percent
46 or more	1,250 percent

If the bank has already made its agreed-upon payments or deliveries and is waiting for performance by a counterparty, capital requirements are triggered immediately. For the first five days after non-performance, the deliverables are risk-weighted at the standard risk weights for those assets. Beyond the five days, the deliverables must be risk-weighted at 1,250 percent.

Securitizations

The Standardized Approach Proposal makes several changes to the regulatory capital treatment of securitizations. Among the changes is a new method of calculating appropriate risk weights, which reflect the mandate in section 939A of the Dodd-Frank Act that the federal banking agencies cease to rely on credit ratings for capital and other purposes. Such credit ratings have been at the core of risk-weighting for securitization exposures. The overall financial impact on a bank of the new rules in the proposal may not be significant, but the changes in methodology will require a thorough review of all of a bank's securitization exposures.

Operational Requirements. In connection with a securitization, a bank typically may be required to hold capital against the securitized assets themselves and against any credit risk that it retains, even if not tied to a specific asset. The proposal would allow a bank to avoid such capital requirements only if the transaction satisfies these requirements:

- The securitized exposures are not reported on the bank's balance sheet under generally accepted accounting principles. In other words, there has been a true sale of the assets.
- The bank has transferred to one or more third parties the credit risk associated with the underlying exposures. That is, there is no recourse to the bank should the value of the securitized exposures decline.
- All clean-up calls are "eligible." A call is eligible if it is (i) solely within the discretion of the originating bank or servicer, (ii) not structured to avoid allocating losses to securitization exposures held by investors or otherwise structured to provide credit enhancements, and (iii) only exercisable when 10 percent or less of the principal amount of the underlying exposures or securitization exposures (determined as of the inception of the securitization) is outstanding.
- The pool does not contain any exposures in which a borrower is permitted to vary the drawn amount within an agreed limit under a line of credit, i.e., the exposures to credit risk cannot vary in amount other than through the borrowers' payment of principal on the loans in the pool.
- The transaction has no early amortization provisions.

If any of these conditions are not satisfied, then the bank must hold risk-based capital against all of the exposures as if they had not been securitized. As previously noted, any gain-on-sale associated with the securitization must be deducted from common equity Tier 1 capital.

Substantively comparable conditions apply to synthetic securitizations. Capital is required based solely on the risk weight of the credit risk mitigant if the following conditions are met:

- The credit risk mitigant either is financial collateral (defined above in connection with the discussion of collateral), an eligible credit derivative, or an eligible guarantee. An eligible guarantee must satisfy several conditions designed to ensure that the bank cannot lose the value of the guarantee through acts outside its control. An eligible credit derivative must satisfy the requirements for an eligible guarantee, as well as other conditions to make certain the protective features of the derivative.
- The bank transfers the credit risk associated with the underlying exposures to one or more third parties.
- The credit risk mitigant does not include any provisions that would, in the event of a deterioration in the credit quality of the underlying exposures, allow for the termination of the credit protection, require the bank to alter or replace the underlying exposures, increase the bank's cost of credit protection, or increase the yield payable to parties other than the bank.
- The bank obtains a "well-reasoned" legal opinion that confirms the enforceability of the credit risk mitigant in all relevant jurisdictions.
- Any clean-up calls are eligible clean-up calls. Eligibility depends on the same criteria of eligibility as in a traditional securitization except that the 10 percent ceiling standard relates to the principal amount of the reference portfolio of underlying exposures (determined as of inception) that is outstanding.

These requirements do not prevent a bank from later taking a position in one of the tranches in a securitization; the risk-weighting of such positions is discussed below.

Due Diligence. Out of a concern that, during the financial crisis, many banks lacked the ability to manage the risks of securitization exposures, the Standardized Approach Proposal directs banks to demonstrate that ability at the outset. This proposed approach al would not require regulatory approval, however, and appears to be a risk management requirement that would be reviewed during the examination process.

The specific requirement is that a bank demonstrate to its regulator that it has a "comprehensive understanding" of the features of a securitization exposure that would materially affect the performance of the exposure. If a bank cannot do so, a punitive risk weight of 1,250 percent will apply to the full securitization exposures held by the bank. A demonstration of such an understanding involves two steps. First, before acquiring an interest in MBS or ABS, the bank must conduct an analysis of the risk characteristics of its interest, including structural features that could affect the performance of the exposure, the performance of the assets or other exposures in the securitized pool, relevant market data on the securitization, and for resecuritization exposures, performance information on the underlying securitization exposures. Second, on an ongoing basis and no less frequently than quarterly, the bank must review and update the foregoing analysis for each securitization exposure.

Methodologies. The Standardized Approach Proposal recognizes two different methods of determining the risk weight of securitization exposure—the Gross-Up Approach and the Simplified Supervisory Formula Approach ("SSFA"). The former already is substantively part of the existing capital rules; the SSFA is new. The SSFA is available to any bank, but the Gross-up Approach is available to banks that are not subject to the market risk capital rules. The Gross-up Approach is all or nothing; a bank that chooses to use it must use it for all of its exposures. In many instances, the SSFA will be the only realistic alternative, thus itself taking on an all-or-nothing quality. Under either approach, the minimum risk weight is 20 percent, even if an approach suggests a lower risk weight. In addition, credit-enhancing interest-only strips must be weighted at 1,250 percent, or dollar-for-dollar.

- **Gross-Up.** This approach reflects the current method for calculating risk weights and corresponding amounts of capital. In general terms, a bank today must hold capital against the dollar amount of its position in a particular tranche plus the dollar amount of all more senior tranches. The proposal explains this approach a little more specifically. The bank's exposure will be its pro rata portion of the par value of the tranche in which its exposure is located plus the appropriate value of all senior tranches. The exposure then would be multiplied by the weighted-average risk weights of the underlying exposures to arrive at the capital charge for the position.

- **SSFA.** This approach measures the credit risk associated with a securitization exposure, that is, the credit risk of the exposures in the securitized pool, in a way that replaces the analysis that a credit rating agency would have performed. The approach requires a bank to begin with the weighted average risk weight of the underlying exposures. This number then is adjusted by several sophisticated algorithms designed to various indicators of credit risk, including delinquencies in the underlying exposures, and the allocation of credit losses to various positions.

Separate rules apply in determining the appropriate risk-based capital amounts for exposures to asset-backed commercial paper facilities.

Equity Exposures

Equity exposures to unconsolidated counterparties will be risk-weighted in one of two ways, depending on whether the exposure is to an entity other than an investment fund, or an investment fund. Equity exposures would include not only securities and other direct ownership (or equivalent) interests, but interests mandatorily convertible into such interests, options or warrants for such interests, or other instruments to the extent the return on such instrument is based on the performance of a direct equity exposure. Equity exposures deducted from Tier 1 or Tier 2 capital, securitization exposures, and ownership interests that provide for periodic payments or similar obligations on the part of the issuer. Equity exposures would be computed according to their adjusted carrying values, which generally would be an exposure's simple carrying value for on-balance-sheet assets, and a formulaic carrying value for off-balance-sheet exposures (or exposure components) that generally would be the exposure's notional value times a specified conversion factor.

Simple Risk-Weight Approach. The current capital rules provide for a simple 100 percent risk-weighting for financial equity exposures, or a deduction from capital for nonfinancial equity exposures (*e.g.*, merchant banking investments under the Bank Holding Company Act). The Standardized Approach Proposal would replace this formula with a tiered risk-weighting formula. Several of the tiers would carry a "penalty" risk-weighting.

- Equity exposures to a sovereign, certain supranational entities, or a MDB multilateral development banks ("MDB) whose debt exposures are eligible for 0 percent risk weight, would be assigned a 0 percent risk weight (*see* discussion below).
- Equity exposures to a PSE, a FHLB, or Farmer Mac would be risk-weighted at 20 percent.
- Equity exposures to (i) community development investments and small business investment companies, (ii) the effective portion of a hedged pair, and (iii) nonsignificant equity investments where the aggregate adjusted carrying values of such investments does not exceed 10 percent of total regulatory capital, would be risk-weighted at 100 percent.
- Significant investments in the capital of unconsolidated financial institutions that are not deducted from capital under the Basel III Proposal would be risk-weighted at 300 percent.
- Most publicly traded equity exposures would be risk-weighted at 300 percent.
- Non-publicly traded equity exposures would be risk-weighted at 400 percent (other than those risk-weighted at 600 percent).
- Equity exposures to certain investment funds (generally, managed securitization pools with greater than "immaterial leverage") would be risk-weighted at 600 percent.

Exposures to Investment Funds. The current capital rules provide for a 20 percent risk-weighting for mutual funds, and for other investment funds either a risk-weighting that is the same as the highest risk-weighted asset the fund is allowed to hold, or a risk-weighting that is the function of the *pro rata* risk weights of assets that are permitted to be held by the fund under the fund's prospectus or governing documents. Under the Standardized Approach Proposal, three alternative approaches are proposed:

- A full look-through approach, which would risk-weight the assets of the fund as if they were owned directly by the bank, multiplied by the bank's proportional ownership in the fund.
- A modified look-through approach, which would be the product of the highest risk weight asset permitted to be held by the fund under its prospectus or governing documents, times the adjusted carrying value of the bank's ownership interest (excluding immaterial derivatives hedges).
- An alternative modified approach, which generally would compute a risk-weight asset amount equal to the sum of each portion of the adjusted

carrying value assigned to each exposure type allowed under the fund's prospectus or governing documents, times the applicable risk weight (excluding immaterial derivatives hedges).

Under this methodology, a "hedged pair" would mean two qualifying equity exposures that form an "effective hedge". The bank, in turn, would risk-weight the effective and ineffective portions of a hedge pair according to a formula, rather than weighting the adjusted carrying values of each constituent exposure.

Sovereign Debt and Foreign Bank Exposures

The Standardized Approach Proposal refines the risk-weighting of sovereign debt and exposures to foreign banks both to better reflect the risks of particular sovereigns and to bring U.S. practices closer to international methods for determining the capital adequacy of these exposures. In very rough terms, the existing U.S. approach relies largely on whether a foreign sovereign is or is not an OECD member and on whether an exposure is unconditionally or conditionally guaranteed by the sovereign. Many foreign regulators have relied on "country risk classifications" ("CRCs") developed by OECD; the Standardized Approach Proposal largely adopts this approach.

The OECD rates country risk on a scale from 0 to 7, with 0 representing the least risk and the 7 the greatest risk. The sovereign debt risk weights in the proposal would increase as the CRC rating declines. The debt of a 0- or 1-rated country will have a zero risk weight, while the sovereign debt of a 7-rated country must be risk-weighted at 150 percent. These risk weights are superseded if a country has defaulted on its debt within the past five years; in such a case, the debt must be risk-weighted at 150 percent.

Exposures to certain supranational entities and multilateral development banks ("MDBs") are currently risk-weighted at 20 percent. The proposal lowers this risk weight to zero and expands the number of MDBs whose debt will be subject to the new risk weight.

The risk weight on the debt of a foreign bank is currently and will continue to be a function of the sovereign debt rating of the country in which the bank is domiciled. Under the existing rules, the foreign bank risk weights are tied to OECD membership. Under the new proposal, the risk weights will be a function of the CRC rating. Bank debt in the least risky countries will be risk-weighted at 20 percent, while the debt of a bank domiciled in a country assigned to one of the four riskiest classifications will be weighted at 150 percent.

The Standardized Approach Proposal also adjusts the risk weights for the debt of political subdivisions within a foreign sovereign. General obligations backed by the full faith and credit of a public sector entity ("PSE") have the same risk weight as a bank obligation in the same country. PSE obligations based on a particular source of revenue are subject to slightly higher risk weights.

C. The Advanced Approaches Proposal

In the third of its three Proposals, the Advanced Approaches Proposal, the Agencies have proposed changes to the Basel II and Basel III regulatory capital framework that applies only to the relatively small number of U.S. banking organizations that are subject to the advanced approaches framework or the market risk rule under Basel II, including qualifying Federal and state savings associations and their holding companies. There is no specified effective date for these changes, if they are adopted.

The Advanced Approaches Proposal would incorporate certain changes to the advanced approaches reflected in the Basel III framework, as well as changes to the Basel II advanced approaches framework made by the Basel Committee between 2006 and 2009. In addition, it would revise the current advanced approaches risk-based capital rules to remove references to credit rating agency ratings, as required by section 939A of the Dodd-Frank Act. More specifically, the Advanced Approaches Proposal would (i) make changes to the calculation of counterparty credit risk, including a more risk-sensitive approach for certain transactions with central counterparties and adjustments to the methodologies used to calculate counterparty credit risk requirements, (ii) remove the references to credit ratings as required by the Dodd-Frank Act, and (iii) strengthen the risk-based capital requirements for certain securitization exposures by requiring affected banking organizations to conduct more rigorous credit analysis of securitization exposures and enhance the disclosure requirements related to these exposures. In conjunction with the adoption of final changes to the market risk capital rule, the Advanced Approaches Proposal proposes to extend the applicability of the market risk capital rule to qualifying Federal and state savings banks and their holding companies.

Counterparty Credit Risk

In general, the Advanced Approaches Proposal would seek to cure areas of weakness in Basel II identified during the recent financial crisis by ensuring that all material on- and off-balance sheet counterparty risks, including those associated with derivative-related exposures, are appropriately incorporated into banking organizations' risk-based capital ratios. In addition, the Advanced Approaches Proposal would incorporate new risk management requirements in Basel III that are designed to strengthen the oversight of counterparty credit risk exposures. The areas of change that are proposed are as follows:

- Revisions to the recognition of eligible financial collateral by excluding resecuritizations and conforming residential mortgages from the definition of eligible collateral, and revising the supervisory haircuts for securitization exposures consistent with changes to Basel III.
- Lengthen the assumed holding periods and the calculation of certain collateralized OTC exposures under the collateral haircut and simple VaR approaches, and the margin period of risk under the internal models methodology, consistent with changes to Basel II and Basel III.
- Increase the capital requirements associated with the internal models methodology, and require better identification and management of wrong-way risk associated with certain counterparty exposures.
- Incorporate an additional capital requirement for credit value adjustments relating to OTC derivatives exposures, and specify the methods of exposure calculation, as directed by Basel III and the changes to Basel II.
- As proposed by Basel III, adjust the capital requirements for qualifying and other CCP exposures of advanced approaches banking organizations that are CCP clearing members, including capital calculations for CCP default fund contributions.

- Require advanced approaches banking organizations to assume a continuous 12-month stress period in calculating market price and foreign volatility exposures under the collateral haircut method, based on internal estimates.

Removal of Credit Rating References

Consistent with section 939A of the Dodd-Frank Act, the Advanced Approaches Proposal would remove references to credit ratings that currently exist in the advanced approaches capital rules and replace these references with alternative standards of creditworthiness. In general, the Agencies would redefine the term "investment grade" that currently is found in the advanced approaches rule to mean that an entity to which the banking organization is exposed through a loan or security, or the reference entity with respect to a credit derivative, has "adequate capacity to meet financial commitments" for the projected life of the asset or exposure. In turn, an entity or reference entity has "adequate capacity to meet financial commitments" if the risk of its default is low and the full and timely repayment of principal and interest is expected. These changes would be comparable to alternative standards proposed in the Standardized Approach Proposal, as well as alternative standards that have been adopted in the Agencies' final market risk capital rule (*see* discussion below).

In the advanced approaches rule, these definitional changes would particularly affect the definitions of "eligible guarantor" (previously "eligible securitization guarantor") and "eligible double default guarantor." The Agencies would remove the ratings-based and internal assessment approaches for securitization exposures and require banking organizations to use the SFA or, where permitted, the SSFA, in calculating their capital requirements for these exposures. In addition, the definitional changes would modify the calculation of potential future exposures for derivative contracts. The Agencies also propose to replace the ratings-based calculations of exposures to money market mutual funds, equity exposures to investment funds, and operational risk exposures with alternative, non-ratings-based risk-weighting exposure calculations for such exposures.

Securitization Exposures

In accordance with changes to Basel II in 2009, the Agencies propose to create a new definition of resecuritization exposures and broaden the definition of securitization exposures, while excluding certain traditional investment firms from that definition. These changes also are consistent with changes proposed in the Standardized Approach Proposal. The resecuritization definition would capture exposures to securitizations that are comprised of asset-backed securities (e.g., CDOs and some ABCP conduits) and that are now subject to higher risk-weightings under the 2009 changes to Basel II.

The proposed changes to securitization exposure capital calculations also would (i) clarify the GAAP-based operational criteria for recognition of risk transfer in traditional securitizations, (ii) revise the existing ratings-based and internal assessment approaches for securitization exposures, (iii) clarify the revised risk-based capital requirements for guarantees or certain credit derivatives referencing a securitization exposure, (iv) enhance due diligence requirements for securitization exposures, and (v) require banking organizations providing credit protection through nth-to-default credit derivatives to assign a risk weight in accordance with the supervisory formula approach or the simplified supervisory formula approach.

Further, in accordance with Basel III, the Agencies propose that certain high-risk securitization exposures previously required to be deducted from capital now generally be assigned a risk-weighting of 1,250 percent instead of being deducted. This change would not apply to securitization exposures (e.g., gain-on-sale exposures) that are required to be deducted from common equity Tier 1 capital under Basel III.

Other Changes

The Advanced Approaches Proposal would make other technical (and not so technical) changes to the advanced approaches rules. These changes would include (i) changes to the treatment of certain contingent obligations of the U.S. government as eligible guarantees, (ii) excluding foreign exposures of insurance underwriting subsidiaries of banking organizations from the $10 billion foreign exposure threshold for treatment as an advanced approaches banking organization, (iii) changes to conform the advanced approaches rules to the Foreign Country Exposure Report (FFIEC 009) used by advanced approaches banking organizations, (iv) for banking organizations that become subject to the advanced approaches rules, preventing their being able to avoid the rule's applicability based on changes in asset size without supervisory approval, (v) changing the effects of seasoning on the probability of default ("PD") for certain retail exposures by subjecting this process to supervisory oversight (Pillar 2) rather than quantitative capital requirements (Pillar 1), (vi) risk-weighting cash items in the process of collection at 20 percent, (vii) clarifying the definition of Qualifying Revolving Exposure to allow certain charge and credit card exposures to qualify under that definition, and (viii) clarifying the maturity floors for trade finance instruments to specify an effective maturity of no less than one year and no greater than five years, except for trade-related letters of credit and certain exposures of under one year's maturity, where the effective maturity must be not less than 1 day.

Finally, the Advanced Approaches Proposal will increase certain "Pillar 3" disclosures required to be made by advanced approaches banking organizations to harmonize the timing and frequency of disclosures with SEC periodic reporting requirements, enhance reporting and disclosure requirements for securitization exposures, and clarify the reporting of equity exposures that are not covered positions.

Expansion of Market Risk Rule Applicability

At the same time as the publication of the Proposals, the Agencies have adopted in final form, effective January 1, 2013, changes to the market risk capital rule that previously were proposed in January 2011 and December 2011 for certain banking organizations that have specified levels of trading assets on their books.[16] With one exception, these final changes track the Basel Committee methodologies for the calculation of market risk capital that were incorporated into Basel II after its initial adoption. As required by section 939A of the Dodd-Frank Act, the market risk capital rule changes have replaced references to credit ratings in the Basel II rules with alternative standards of creditworthiness.

In conjunction with the adoption of these changes to the market risk capital rule, the Advanced Approaches Proposal would extend the reach of the market risk capital rule to federal and state savings banks and their holding companies that meet the rule's qualification thresholds. As noted above, the market risk capital rule presently applies to any bank with aggregate trading assets and trading liabilities equal to 10 percent or more of total assets of at least $1 billion.

Some Initial Observations

Given the breadth, complexity and potential impact of the Proposals, the comment period allows U.S. banking organizations and other interested persons relatively little time to understand their requirements and assess their potential impact on their activities and operations. We expect that the U.S. banking industry will be concerned about the impact of these Proposals on core matters such as the availability and costs of equity capital, the economic costs of the capital requirements as they apply to commercial and residential mortgage lending activities and other classes of assets on the banking book, the competitive impact (both domestically and internationally) of the Proposals, and the associated compliance burdens and costs, among other issues.

Smaller banking organizations in particular may view the two Proposals that apply to them (the Basel III Proposal and the Standardized Approach Proposal) as an unnecessary and unwelcome burden that goes well beyond the intended scope of Basel II and Basel III, and that is not required by the Dodd-Frank Act or any other U.S. law. While these banking organizations may be correct on the substantive merits of this point, the current U.S. regulatory and political climate creates formidable obstacles for those parts of the banking industry that might want to argue that they should be excluded from these general capital requirements.

By the same token, the advanced approaches and market risk banking organizations that would be subject to the changes proposed by the Advanced Approaches Proposal should be less surprised by the general tenor and scope of that Proposal, inasmuch as they are designed to be consistent with more recent Basel Committee changes to Basel II, as well as Basel III. At the same time, there may be plenty in the specifics of the Advanced Approaches Proposal that the advanced approaches banking organizations may want to see modified.

Of course, there will be much discussion and debate over the impact of the Proposals on the capital-raising activities of banking organizations, and the extent to which the Agencies will be receptive to innovations in capital instruments that are structured to comply with the new Basel III-based requirements, in particular additional Tier 1 and Tier 2 capital. In this regard, there does not appear to be much space for flexibility in what qualifies as common equity Tier 1 capital, but there may be more room for innovation for new Tier 1 and Tier 2 instruments. At the same time, it is not clear how much flexibility the Agencies will exercise in making these capital determinations, although we fairly can expect the capital markets to use their usual creativity in going about the task of designing new regulation-compliant instruments.

The Standardized Approach Proposal will materially complicate the risk-weighting calculation processes of those banking organizations that have not had to be concerned with Basel II up until now. Even those non-complex smaller banks that are not subject to the full range of these new requirements, or do not have OTC derivatives or other complex exposures, will be faced with the task of applying more complicated methodologies and formulas to the risk-weighting of their assets.

A more interesting question may be the impact of the new rules on banking organizations' lending and other asset-related activities. For instance, the risk weights for residential and commercial real estate exposures are being reformulated to discourage the holding of riskier loan assets of this nature, and sovereign exposures will be subjected to more granular risk-weighting treatment. These types of financial behavior incentives in the past have influenced – some may say distorted – the balance sheets of banking organizations, and it will be interesting to see how much of a behavior modification impact the Standardized Approach Proposal may have. This is one area in which the "law of unintended consequences" may loom large, and it will bear close watching if these Proposals are adopted.

Does it matter, from an international competitive standpoint, that there are some differences, albeit not very large, between the U.S. Proposals on the one hand, and the Basel III and proposed European capital requirements on the other hand? For international U.S. banks, and even for U.S. banks that do not have international operations, there always is the possibility that EU and other international banks doing business in the U.S. under their home jurisdictions' – and not U.S. – regulatory capital requirements may gain some competitive advantages by reason of not being subject to U.S. rules. However, at this point in time, the nature and scope of the apparent differences between the proposed U.S. and non-U.S. capital frameworks generally would not appear to create substantial competitive equality issues, although ultimately time will tell whether this continues to be the case.

One possible exception to this last point, however, may be the greater flexibility under the Basel III and EU capital regimes to treat certain types of hybrid capital or "bail-in" instruments with debt characteristics as additional Tier 1 capital, whereas such an outcome is precluded under the Agencies' Basel III Proposal. On the reverse side of the competitive equality ledger, however, the EU's proposed CRD4 would apply the countercyclical capital buffer to all EU banking organizations, and Basel III would apply the same buffer to all banking organizations (whether subject to the standardized, foundation IRB or advanced approaches) that are subject to Basel II, whereas under the U.S. Proposals, only the advanced approaches banking organizations would be subject to the countercyclical capital buffer.

How amenable will the Agencies be to making changes to the Proposals? The three proposing releases collectively ask approximately 80 questions (primarily with respect to the Basel III Proposal) on the various aspects of the Proposals, but the nature and tenor of these does not reveal substantial hesitation or uncertainty on the Agencies' part with respect to the Proposals.

All this being said, it will take additional time and substantial additional work to sort out more fully the more specific impact and implications of the Proposals for U.S. banking organizations and the U.S. banking industry. As the discussion progresses, we look forward to reporting further on these far-reaching Proposals and their ramifications for U.S. banks and the U.S. financial system.

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[1] Office of the Comptroller of the Currency ("OCC"), Federal Reserve Board, Federal Deposit Insurance Corporation ("FDIC"), Regulatory Capital Rules: (i) Implementation of Basel III; Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Periods and Prompt Corrective Action ("Basel III Proposal"); (ii) Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements ("Standardized Approach Proposal"); and (iii) Advanced Approaches Risk-Based Capital Rule; Market Risk

Capital Rule ("Advanced Approaches Proposal"). All three of these Proposals were first approved and published by the Federal Reserve Board on June 7, 2012, but the three Agencies jointly announced their publication on June 12.

[2] Basel Committee on Banking Supervision ("Basel Committee"), *Basel III: A global regulatory framework for more resilient banks and banking systems* (Dec. 2010; rev. June 2011).

[3] Basel Committee on Banking Supervision, *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (rev. comprehensive version June 2006).

[4] 12 C.F.R. Part 3, Appendix C, and 12 C.F.R. Part 167, Appendix C (Office of the Comptroller of the Currency); 12 C.F.R. Part 208, Appendix F, and 12 C.F.R. Part 225, Appendix G (Federal Reserve Board); and 12 C.F.R. Part 325, Appendix D, and 12 C.F.R. Part 390, Subpart Z (Federal Deposit Insurance Corporation).

[5] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010), section 165 [codified to 12 U.S.C. 5365].

[6] European Commission – *legislative proposal for a new capital requirements directive* (CRD4) (July 20, 2011).

[7] Dodd-Frank Act section 171 [codified to 12 U.S.C. 5371].

[8] This is not a surprising outcome, inasmuch as the Dodd-Frank Act "Collins Amendment" (section 171) effectively disqualified the TruPS of most banking organizations from Tier 1 capital treatment.

[9] In addition, to align the requirements under the Home Owners Loan Act ("HOLA") that Federal savings associations maintain a minimum ratio of 1.5% "tangible equity" to total assets with other changes to the regulatory capital rules, the OCC for Federal savings banks, and the FDIC for state savings banks, propose to adopt a uniform definition of "tangible equity" for HOLA and PCA purposes.

[10] Banks and bank holding companies with less than $500 million in consolidated assets would be exempt from the requirements in the Standardized Approach Proposal. The Proposal would apply to all savings associations and savings and loan holding companies, regardless of size. For convenience, we simply refer to institutions covered by the Standardized Approach Proposal collectively as "banks."

[11] The proposal does not change the risk weights for the debt of the U.S. government and its agencies, government-sponsored enterprises, depository institutions and credit unions, and PSEs.

[12] At some banks, these category 2 risk weights theoretically could be a reduction from current requirements. Over the past several years, the U.S. bank regulators have required some banks to risk-weight subprime loans at 300 percent. The Proposal would not affect the regulators' discretion to set higher requirements for specific institutions, and it is unlikely that the regulators would reduce any existing requirements solely on the basis of the Proposal.

[13] The bank must "conduct sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review)" that the protective arrangements would survive any legal challenge.

[14] Although the Proposal does not discuss a Title VIII designation in any further detail, a "designation" under Title VIII entails a determination by the Financial Stability Oversight Council that the failure or disruption of the utility could ultimately threaten the stability of the U.S. financial system.

[15] Collateral securing repo-style transactions must also be included in a bank's Value-at-Risk ("VaR") measurements.

[16] OCC, Federal Reserve Board, FDIC, Risk-Based Capital Guidelines: Market Risk (June 12, 2012).

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Appendix A

1. Common Equity Tier 1 Capital

Common equity Tier 1 capital would be the sum of: outstanding common equity Tier 1 capital instruments and related surplus (net of treasury stock), retained earnings, accumulated other comprehensive income ("AOCI"), and qualifying common equity Tier 1 minority interest, minus any required regulatory adjustments and deductions.

Criteria

Common equity Tier 1 capital instruments issued by a banking organization must satisfy the following criteria:

1. The instrument is paid in, issued directly by the banking organization, and represents the most subordinated claim in a receivership, insolvency, liquidation, or similar proceeding of the banking organization.

2. The holder of the instrument is entitled to a claim on the residual assets of the banking organization that is proportional with the holder's share of the banking organization's issued capital after all senior claims have been satisfied in a receivership, insolvency, liquidation, or similar proceeding.

3. The instrument has no maturity date, can only be redeemed via discretionary repurchases with the prior approval of the agency, and does not contain any term or feature that creates an incentive to redeem.

4. The banking organization did not create at issuance of the instrument through any action or communication an expectation that it will buy back, cancel, or redeem the instrument, and the instrument does not include any term or feature that might give rise to such an expectation.

5. Any cash dividend payments on the instrument are paid out of the banking organization's net income and retained earnings, and are not subject to a limit imposed by the contractual terms governing the instrument.

6. The banking organization has full discretion at all times to refrain from paying any dividends and making any other capital distributions on the instrument without triggering an event of default, a requirement to make a payment-in-kind, or an imposition of any other restrictions on the banking organization.

7. Dividend payments and any other capital distributions on the instrument may be paid only after all legal and contractual obligations of the banking organization have been satisfied, including payments due on more senior claims.

8. The holders of the instrument bear losses as they occur equally, proportionately, and simultaneously with the holders of all other common stock instruments before any losses are borne by holders of claims on the banking organization with greater priority in a receivership, insolvency, liquidation, or similar proceeding.

9. The paid-in amount is classified as equity under GAAP.

10. The banking organization, or an entity that the banking organization controls, did not purchase or directly or indirectly fund the purchase of the instrument.

11. The instrument is not secured, not covered by a guarantee of the banking organization or of an affiliate of the banking organization, and is not subject to any other arrangement that legally or economically enhances the seniority of the instrument.

12. The instrument has been issued in accordance with applicable laws and regulations.

13. The instrument is reported on the banking organization's regulatory financial statements separately from other capital instruments.

2. Additional Tier 1 Capital

Additional tier 1 capital would be the sum of: additional Tier 1 capital instruments that satisfy certain criteria, related surplus, and qualifying Tier 1 minority interest that is not included in a banking organization's common equity Tier 1 capital, minus any required regulatory adjustments and deductions.

Criteria

Additional Tier 1 capital instruments issued by a banking organization must satisfy the following criteria:

1. The instrument is issued and paid in.

2. The instrument is subordinated to depositors, general creditors, and subordinated debtholders of the banking organization in a receivership, insolvency, liquidation, or similar proceeding.

3. The instrument is not secured, not covered by a guarantee of the banking organization or of an affiliate of the banking organization, and not subject to any other arrangement that legally or economically enhances the seniority of the instrument.

4. The instrument has no maturity date and does not contain a dividend step-up or any other term or feature that creates an incentive to redeem.

5. If callable by its terms, the instrument may be called by the banking organization only after a minimum of five years following issuance, except that the terms of the instrument may allow it to be called earlier than five years upon the occurrence of a regulatory event (as defined in the agreement governing the instrument) that precludes the instrument from being included in additional Tier 1 capital or a tax event. In addition:

   (i) The banking organization must receive prior approval from its supervisory agency to exercise a call option on the instrument.

   (ii) The banking organization does not create at issuance of the instrument, through any action or communication, an expectation that the call option will be exercised.

   (iii) Prior to exercising the call option, or immediately thereafter, the banking organization must either:

      (A) Replace the instrument to be called with an equal amount of instruments that meet the criteria for common equity or additional Tier 1 capital; or

      (B) Demonstrate to the satisfaction of the banking organization's supervisory agency that following redemption, the banking organization will continue to hold capital commensurate with its risk.

6. Redemption or repurchase of the instrument requires prior approval from the banking organization’s supervisory agency.

7. The banking organization has full discretion at all times to cancel dividends or other capital distributions on the instrument without triggering an event of default, a requirement to make a payment-in-kind, or an imposition of other restrictions on the banking organization except in relation to any capital distributions to holders of common stock.

8. Any capital distributions on the instrument are paid out of the banking organization’s net income and retained earnings.

9. The instrument does not have a credit-sensitive feature, such as a dividend rate that is reset periodically based in whole or in part on the banking organization’s credit quality, but may have a dividend rate that is adjusted periodically independent of the banking organization’s credit quality, in relation to general market interest rates or similar adjustments.

10. The paid-in amount is classified as equity under GAAP.

11. The banking organization, or an entity that the banking organization controls, did not purchase or directly or indirectly fund the purchase of the instrument.

12. The instrument does not have any features that would limit or discourage additional issuance of capital by the banking organization, such as provisions that require the banking organization to compensate holders of the instrument if a new instrument is issued at a lower price during a specified time frame.

13. If the instrument is not issued directly by the banking organization or by a subsidiary of the banking organization that is an operating entity, the only asset of the issuing entity is its investment in the capital of the banking organization, and proceeds must be immediately available without limitation to the banking organization or to the banking organization’s top-tier holding company in a form which meets or exceeds all of the other criteria for additional Tier 1 capital instruments. *De minimis* assets related to the operation of the issuing entity can be disregarded for purposes of this criterion.

14. For an *advanced approaches banking organization*, the governing agreement, offering circular, or prospectus of an instrument issued after January 1, 2013 must disclose that the holders of the instrument may be fully subordinated to interests held by the U.S. government in the event that the banking organization enters into a receivership, insolvency, liquidation, or similar proceeding.

3. Tier 2 Capital

Tier 2 capital would be the sum of: Tier 2 capital instruments that satisfy certain criteria, related surplus, total qualifying capital minority interests not included in a banking organization's Tier 1 capital, and limited amounts of the allowance for loan and lease losses, minus any required regulatory adjustments and deductions.

Criteria

Tier 2 capital instruments issued by a banking organization must satisfy the following criteria:

1. The instrument is issued and paid in.

2. The instrument is subordinated to depositors and general creditors of the banking organization.

3. The instrument is not secured, not covered by a guarantee of the banking organization or of an affiliate of the banking organization, and not subject to any other arrangement that legally or economically enhances the seniority of the instrument in relation to more senior claims.

4. The instrument has a minimum original maturity of at least five years. At the beginning of each of the last five years of the life of the instrument, the amount that is eligible to be included in Tier 2 capital is reduced by 20 percent of the original amount of the instrument (net of redemptions) and is excluded from regulatory capital when remaining maturity is less than one year. In addition, the instrument must not have any terms or features that require, or create significant incentives for, the banking organization to redeem the instrument prior to maturity.

5. The instrument, by its terms, may be called by the banking organization only after a minimum of five years following issuance, except that the terms of the instrument may allow it to be called sooner upon the occurrence of an event that would preclude the instrument from being included in Tier 2 capital, or a tax event. In addition:

   (i) The banking organization must receive the prior approval of its supervisory agency to exercise a call option on the instrument.

   (ii) The banking organization does not create at issuance, through action or communication, an expectation that the call option will be exercised.

   (iii) Prior to exercising the call option, or immediately thereafter, the banking organization must either:

      (A) Replace any amount called with an equivalent amount of an instrument that meets the criteria for Tier 1 or Tier 2 regulatory capital, or

(B) Demonstrate to the satisfaction of its supervisory agency that following redemption, the banking organization would continue to hold an amount of capital that is commensurate with its risk.

6. The holder of the instrument must have no contractual right to accelerate payment of principal or interest on the instrument, except in the event of a receivership, insolvency, liquidation, or similar proceeding of the banking organization.

7. The instrument has no credit-sensitive feature, such as a dividend or interest rate that is reset periodically based in whole or in part on the banking organization's credit standing, but may have a dividend rate that is adjusted periodically independent of the banking organization's credit standing, in relation to general market interest rates or similar adjustments.

8. The banking organization, or an entity that the banking organization controls, has not purchased and has not directly or indirectly funded the purchase of the instrument.

9. If the instrument is not issued directly by the banking organization or by a subsidiary of the banking organization that is an operating entity, the only asset of the issuing entity is its investment in the capital of the banking organization, and proceeds must be immediately available without limitation to the banking organization or the banking organization's top-tier holding company in a form that meets or exceeds all the other criteria for Tier 2 capital instruments under this section.

10. Redemption of the instrument prior to maturity or repurchase requires the prior approval of the banking organization's supervisory agency.

11. For an *advanced approaches banking organization*, the governing agreement, offering circular, or prospectus of an instrument issued after January 1, 2013 must disclose that the holders of the instrument may be fully subordinated to interests held by the U.S. government in the event that the banking organization enters into a receivership, insolvency, liquidation, or similar proceeding.