

## U.S. Basel III Capital Proposed Rules and Market Risk Final Rule: Out with the Old, In with the New

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Led by the Federal Reserve Board on June 7, 2012, the three federal banking agencies are proposing a broad and comprehensive revision of the regulatory capital rules applicable to all U.S. national banks, state member and nonmember banks, state and federal savings associations, all U.S. bank holding companies except those with less than \$500 million in total consolidated assets, and all U.S. savings and loan holding companies (regardless of size or whether they are primarily insurance holding companies) (collectively, “**U.S. Banking Organizations**”). The new rules represent the most complete overhaul of U.S. bank capital standards since the adoption of Basel I in 1989. Once they are fully implemented, the new rules will in fact completely replace the agencies’ existing Basel I-based capital requirements (“**general capital rules**”) and, compared to Basel I, will generally require U.S. Banking Organizations to hold higher amounts of capital, especially common equity, against their risk-weighted assets. Please refer to the diagram in [Appendix A](#) for a graphic representation of these new capital requirements. Please see [Table 1](#) below for details regarding the scope of application of the new rules.

The new rules are intended to implement the Basel III capital standards, although there are some differences in timing and scope of implementation, as well as revisions to the rules for calculating capital charges for market risk (commonly known as “**Basel 2.5**”). They are also intended to comply with the Dodd-Frank Act’s requirements that all insured depository institutions (“**IDIs**”) and their holding companies be subject to the same generally applicable risk-based capital and leverage rules (Section 171, commonly referred to as the “**Collins Amendment**”) and that all references to external credit ratings be removed from federal agencies’ regulations and replaced with new standards of creditworthiness (“**Section 939A**”).

The effectiveness of the new rules will be phased in according to different start dates, ranging from January 1, 2013 to January 1, 2018, and different phase-in periods, ranging from two years to nine years. Not until January 1, 2022 will the new rules be fully implemented for all U.S. Banking Organizations. Please refer to the timeline in [Appendix B](#) for details regarding transitional arrangements and effective dates.

The new rules consist of three notices of proposed rulemaking (“**NPRs**”) and one final rule:

- The **Basel III Capital NPR**, which introduces the Basel III standards for the components of, adjustments to and deductions from regulatory capital (the numerator in U.S. Banking Organizations’ risk-based capital and leverage ratios), as well as the new minimum ratios under the prompt corrective action (“**PCA**”) framework. The Basel III Capital NPR would apply to all U.S. Banking Organizations, with a few elements that apply only to U.S. Banking Organizations that are subject to the advanced approaches rules (“**Advanced Approaches Banking Organizations**”).
- The **Standardized Approach NPR**, which generally introduces a modified version of the Basel II standardized approach for calculating risk-weighted assets (the denominator in U.S. Banking Organizations’ risk-based capital ratios) and would, together with the Basel III Capital NPR, become the new Collins Amendment “floor” for Advanced Approaches Banking Organizations.
- The **Advanced Approaches NPR**, which modifies the existing Basel II advanced approaches rules for calculating risk-weighted assets to implement Basel III and to comply with Section 939A and also applies both the advanced approaches risk and the Market Risk Final Rule to savings associations and savings and loan holding companies that meet the applicable thresholds.
- The **Market Risk Final Rule**, which modifies the existing market risk rules to implement Basel 2.5 and to comply with Section 939A. This rule applies to U.S. Banking Organizations that have significant trading activity (“**Market Risk Banking Organizations**”).

The comment deadline for all three NPRs is September 7, 2012. The Market Risk Final Rule becomes effective on January 1, 2013.

This client newsflash provides a general, high-level summary of the three NPRs and the Market Risk Final Rule. Basel III and other U.S. regulatory capital issues will be explored in greater depth in forthcoming memoranda.

**Table 1: Scope of Application of NPRs and Market Risk Final Rule**

Rulemaking	Scope of Application	Comments
<b>Basel III Capital NPR</b>	National banks; State member banks; State nonmember banks; State and federal savings associations; Top-tier bank holding companies domiciled in the United States with \$500 million or more in total assets; and Top-tier savings and loan holding companies domiciled in the United States (collectively, “ <b>U.S. Banking Organizations</b> ”)	Aspects of the Basel III Capital NPR would only apply to <b>Advanced Approaches Banking Organizations</b> : <ul style="list-style-type: none"> <li>Basel III Leverage Ratio;</li> <li>Countercyclical Buffer (if deployed); and</li> <li>Loss-absorbency disclosures for Additional Tier 1 and Tier 2 capital instruments issued after January 1, 2013.</li> </ul>
<b>Standardized Approach NPR</b>	<b>U.S. Banking Organizations</b>	An <b>Advanced Approaches Banking Organization</b> would have to calculate its risk-based capital ratios under <b>both</b> the revised general capital rules (consisting of the Basel III Capital NPR and the Standardized Approach NPR, as implemented, plus the Market Risk Final Rule, if applicable) and the revised advanced approaches rules (consisting of the Advanced Approaches NPR, as implemented, plus the Market Risk Final Rule, if applicable) and then use the <b>lower</b> of each of the two Common Equity Tier 1 capital ratios, Tier 1 capital ratios and Total capital ratios to determine whether it meets its minimum risk-based capital requirements.
<b>Advanced Approaches NPR</b>	U.S. Banking Organizations with \$250 billion or more in consolidated total assets <b>or</b> \$10 billion or more in consolidated total on-balance sheet foreign exposure (“ <b>Advanced Approaches Banking Organizations</b> ”).  NPR would extend the market risk rules to savings associations that cross certain activity thresholds and would extend the advanced approaches rules and the market risk rules to top-tier U.S. savings and loan holding companies that cross certain activity thresholds.	
<b>Market Risk Final Rule</b>	U.S. Banking Organizations that have aggregated trading assets and liabilities of at least \$1 billion or 10% of total assets (“ <b>Market Risk Banking Organizations</b> ”).*  * An Advanced Approaches Banking Organization may also be a Market Risk Banking Organization.	Advanced Approaches NPR would extend the market risk rules to savings associations that cross certain activity thresholds and would extend the advanced approaches rules and the market risk rules to top-tier U.S. savings and loan holding companies that cross certain activity thresholds.

## Overview of NPRs and Market Risk Final Rule

**Basel III Capital NPR.**<sup>1</sup> Applicable to all U.S. Banking Organizations, this NPR would implement many aspects of Basel III<sup>2</sup> that increase the quantity and quality of regulatory capital, particularly with respect to the **numerator** of a banking organization's risk-based capital ratios, including:

- subjecting U.S. Banking Organizations to the following minimum regulatory capital requirements: a Common Equity Tier 1 capital ratio of 4.5% (newly introduced requirement), a Tier 1 capital ratio of 6% (increased from the current 4%), a Total capital ratio of 8% of total risk-weighted assets (unchanged from the current requirement) and a Tier 1 leverage ratio of 4%;
- introducing regulatory capital buffers above the minimum Common Equity Tier 1 ratio, including a capital conservation buffer of a further 2.5% of Common Equity Tier 1 capital to risk-weighted assets and, for Advanced Approaches Banking Organizations, a countercyclical buffer of up to 2.5% of Common Equity Tier 1 capital to risk-weighted assets that *may* be deployed as an extension of the capital conservation buffer;
- re-defining regulatory capital elements resulting in, among other things, cumulative perpetual preferred stock and trust preferred instruments no longer qualifying as Tier 1 capital, subject to a phase-out schedule that is consistent with the Collins Amendment;
- revising regulatory deductions from and adjustments to capital, the vast majority of which apply to Common Equity Tier 1 capital (instead of Tier 1 or Total capital) and providing that unrealized gains and losses on all available for sale debt securities would *not* be filtered out for regulatory capital purposes;
- applying to Advanced Approaches Banking Organizations, as a supplementary leverage ratio in addition to the Tier 1 leverage ratio, the Basel III Tier 1 leverage ratio, which takes into account both on- and off-balance sheet exposures in the denominator; and
- providing for transitional arrangements that are broadly consistent with the transitional arrangements in Basel III, subject to differences mandated by the Collins Amendment.

**Standardized Approach NPR.**<sup>3</sup> Applicable to all U.S. Banking Organizations, this NPR would increase the risk sensitivity of the agencies' general capital rules, currently based on Basel I, for determining risk-weighted assets—*i.e.*, the **denominator** of a banking organization's risk-based capital ratios. Among other things, the Standardized Approach NPR would: (i) generally introduce a modified version of the Basel II<sup>4</sup> standardized approach; (ii) rely on alternatives to external credit ratings for the treatment of certain exposures, as required by Section 939A; and (iii) introduce other changes to increase the risk-sensitivity of risk-weighted assets calculations. The proposed effective date of the Standardized Approach NPR is January 1, 2015, although U.S. Banking Organizations have the option to adopt it earlier.

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<sup>1</sup> Federal Reserve Board, FDIC and OCC, "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action" ("**Basel III Capital NPR**"), available [here](#).

<sup>2</sup> Basel Committee, "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" (Dec. 2010, revised Jun. 2011), available [here](#).

<sup>3</sup> Federal Reserve Board, FDIC and OCC, "Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements" ("**Standardized Approach NPR**"), available [here](#).

<sup>4</sup> Basel Committee, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (Jun. 2006), available [here](#).

**Advanced Approaches NPR.**<sup>5</sup> This NPR would amend the agencies' advanced approaches rules for calculating an Advanced Approaches Banking Organization's risk-weighted assets by, among other things, incorporating aspects of Basel III and other revisions to the Basel capital framework made by the Basel Committee in a series of documents between 2009 and 2011 and subsequent consultative papers. The primary focus of the revisions is on counterparty credit risk and the securitization exposure framework.

**Market Risk Final Rule.**<sup>6</sup> Applicable to Market Risk Banking Organizations, the Market Risk Final Rule amends the agencies' market risk rules to implement Basel 2.5<sup>7</sup> in the United States, relying on alternatives to external credit ratings as required by Section 939A. The Market Risk Final Rule will be effective on January 1, 2013.

**Liquidity Framework and G-SIB Surcharge Not Part of NPRs.** The quantitative liquidity framework under Basel III<sup>8</sup> (including the liquidity coverage ratio and the net stable funding ratio) and the Basel Committee's Common Equity Tier 1 capital surcharge for global systemically important banks ("**G-SIBs**")<sup>9</sup> are not part of the NPRs. The Federal Reserve Board noted that it intends to propose a quantitative risk-based capital surcharge in the United States based on the G-SIB surcharge, to be phased in from January 1, 2016 to January 1, 2019. The OCC also noted that it is reviewing the Basel Committee's work in this area and is considering whether to propose a similar surcharge for globally significant national banks.

**Prohibition against Reliance on External Credit Ratings.** Consistent with the statutory mandate under Section 939A, the agencies proposed alternatives to external credit ratings in the Standardized Approach NPR and in the Advanced Approaches NPR, some of which are broadly similar to the alternatives adopted in the Market Risk Final Rule.

**Collins Amendment Floor.** According to the agencies, the requirements in the Basel III Capital NPR and Standardized Approach NPR are proposed to become the "generally applicable" capital requirements for purposes of the Collins Amendment because they would be the capital requirements applied to IDIs under Section 38 of the Federal Deposit Insurance Act, without regard to asset size or foreign financial exposure. This implies that the agencies have determined that these proposed requirements are not quantitatively lower than the Collins Amendment's historical capital floor—*i.e.*, the generally applicable risk-based and leverage capital requirements that were in effect for U.S. IDIs as of the date of enactment of the Dodd-Frank Act. If adopted, these proposed requirements would become the minimum capital floor for all U.S. Banking Organizations. As a result, an Advanced Approaches Banking Organization would have to calculate its risk-based capital ratios under both the revised "generally applicable" capital requirements (consisting of the Basel III Capital NPR and the Standardized Approach NPR, as implemented, plus the Market Risk Final Rule, if applicable) and the revised advanced approaches rules (consisting of the Advanced Approaches NPR, as implemented, plus the Market Risk Final Rule, if

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<sup>5</sup> Federal Reserve Board, FDIC and OCC, "Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule" ("**Advanced Approaches NPR**"), [available here](#).

<sup>6</sup> Federal Reserve Board, FDIC and OCC, "Risk-Based Capital Guidelines: Market Risk" ("**Market Risk Final Rule**"), [available here](#).

<sup>7</sup> Basel Committee, "Revisions to the Basel II Market Risk Framework" (Updated as of Dec. 31, 2010), [available here](#); "Guidelines for Computing Capital for Incremental Risk in the Trading Book" (Jul. 2009), [available here](#).

<sup>8</sup> Basel Committee, "Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring" (Dec. 2010), [available here](#).

<sup>9</sup> Basel Committee, "Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement (Rules Text)" (Nov. 2011), [available here](#).

applicable) and then use the *lower* of each of the two Common Equity Tier 1 capital ratios, Tier 1 capital ratios and Total capital ratios to determine whether it meets its minimum risk-based capital requirements.

**Certain U.S. Bank Holding Company (“BHC”) Subsidiaries of Foreign Banks.** Consistent with the Dodd-Frank Act, a U.S.-domiciled BHC subsidiary of a foreign banking organization that is currently relying on the Federal Reserve Board’s Supervision and Regulation Letter (SR) 01-1 “would not be required to comply with the proposed capital requirements under any of these NPRs until July 21, 2015.”

**Savings and Loan Holding Companies.** In light of the transfer of supervisory responsibilities to the Federal Reserve Board and the requirements in the Collins Amendment, the agencies proposed to generally apply the NPRs to savings and loan holding companies, which are not currently subject to consolidated capital requirements. The Standardized Approach NPR contains provisions pertaining to the determination of risk-weighted assets for nonbanking exposures unique to insurance underwriting activities. The Advanced Approaches NPR would also extend the market risk rules to savings associations that cross certain activity thresholds and would extend the advanced approaches rules and the market risk rules to top-tier U.S. savings and loan holding companies that cross certain activity thresholds.

## New Minimum Capital Ratios and New Capital Buffers

Please refer to [Appendix A](#) for a visual representation of these new capital requirements.

### Minimum Risk-Based Capital Ratios

Consistent with Basel III, the agencies proposed to require all U.S. Banking Organizations to meet the following minimum risk-based capital ratios, which would be phased in beginning on January 1, 2013 and fully implemented by January 1, 2015. Please refer to [Appendix B](#) for details regarding phase-in arrangements.

- Common Equity Tier 1 capital ratio of 4.5%
- Tier 1 capital ratio (Common Equity Tier 1 capital plus Additional Tier 1 capital) of 6.0%
- Total capital ratio (Tier 1 capital plus Tier 2 capital) of 8.0%

As a result of these proposed changes, Common Equity Tier 1 capital will become the predominant form of Tier 1 capital and of Total capital. The agencies also noted that, as a prudential matter, a U.S. Banking Organization is generally expected to operate with capital positions well above the minimum risk-based ratios, particularly if it is contemplating significant expansion or has high levels of risk.

### Minimum Leverage Capital Ratios

For all U.S. Banking Organizations, the Basel III Capital NPR would modify the current U.S. minimum leverage ratio requirement (“**U.S. Leverage Ratio**”) to reflect the new definition of Tier 1 capital (see below). For Advanced Approaches Banking Organizations, the Basel III Capital NPR introduces a supplementary leverage ratio requirement, based on the Basel III leverage ratio, which incorporates certain off-balance sheet assets in the denominator (“**Basel III Supplementary Leverage Ratio**”). Advanced Approaches Banking Organizations would continue to be subject to the U.S. Leverage Ratio.

**Minimum U.S. Leverage Ratio.** Tier 1 capital (under new eligibility criteria) to average total consolidated assets must be at least 4%. This applies to all U.S. Banking Organizations.

- The agencies proposed to retain the U.S. Leverage Ratio, which only takes into account a banking organization’s on-balance sheet assets. While leaving the U.S. Leverage Ratio unchanged, the Basel III Capital NPR would eliminate the 3% minimum U.S. Leverage Ratio that currently applies to banking organizations with a composite CAMELS or other applicable supervisory rating of 1 that do



not expect to grow significantly. Accordingly, as proposed, all U.S. Banking Organizations would be subject to a minimum 4% U.S. Leverage Ratio.

**Minimum Basel III Supplementary Leverage Ratio.** Tier 1 capital to “total leverage exposure” must be at least 3%. This applies only to Advanced Approaches Banking Organizations.

- The denominator of the proposed Basel III Supplementary Leverage Ratio includes, in addition to on-balance sheet assets minus deductions from Tier 1 capital, a number of off-balance sheet exposures: (i) potential future exposure for derivatives; (ii) 10% of the notional amount of unconditionally cancellable commitments; and (iii) the notional amount of all other off-balance sheet exposures of the banking organization (excluding securities lending, securities borrowing, reverse repurchase transactions, derivatives and unconditionally cancellable commitments).
- Beginning on January 1, 2018, Advanced Approaches Banking Organizations would have to adhere to the Basel III Supplementary Leverage Ratio in addition to continuing to comply with the U.S. Leverage Ratio that is applicable to all U.S. Banking Organizations. Advanced Approaches Banking Organizations would need to calculate and report the Basel III Supplementary Leverage Ratio beginning on January 1, 2015.

### **Common Equity Tier 1 Capital Conservation and Countercyclical Capital Buffers**

Consistent with Basel III, all U.S. Banking Organizations would be required to maintain a capital conservation buffer, consisting of a further 2.5% of Common Equity Tier 1 capital to risk-weighted assets, on top of minimum risk-based capital ratios. In addition, the Basel III Capital NPR would authorize the agencies to require all Advanced Approaches Banking Organizations to maintain a countercyclical buffer of up to 2.5% of Common Equity Tier 1 capital to risk-weighted assets as an extension to the capital conservation buffer during times of excessive credit growth. Consistent with the general understanding that these capital buffers, strictly speaking, are not intended to be minimum capital requirements, the Basel III Capital NPR clarifies that they would not be incorporated into the PCA framework.

**Capital Conservation Buffer for All U.S. Banking Organizations.** Under the Basel III Capital NPR, all U.S. Banking Organizations must maintain a 2.5% Common Equity Tier 1 capital conservation buffer to avoid limitations on capital distributions, such as repurchases of capital instruments or dividend or interest payments on capital instruments, and discretionary bonus payments to executive officers such as the CEO, president, CFO, CIO, CLO and heads of major lines of business. The proposed definition of capital distribution is similar to the definition of capital distribution in the Federal Reserve Board’s capital planning final rule for BHCs with \$50 billion or more in total assets. In light of the consequences of falling below the buffer, the capital conservation buffer will likely become a *de facto* component of the minimum capital requirement.

As a banking organization dips further below the capital conservation buffer, it will be subject to increasingly stringent limitations on capital distributions and bonus payments (see table below). As proposed, a U.S. Banking Organization’s capital conservation buffer would be the lowest of the following three measures: (i) its Common Equity Tier 1 capital ratio minus its minimum Common Equity Tier 1 capital ratio; (ii) its Tier 1 capital ratio minus its minimum Tier 1 capital ratio; and (iii) its Total capital ratio minus its minimum Total capital ratio. If any one of the banking organization’s Common Equity Tier 1, Tier 1 or Total capital ratio were less than or equal to the respective minimum requirements, the banking organization’s capital conservation buffer would be zero.

Consistent with Basel III, the capital conservation buffer requirement would be phased in from January 1, 2016. Please refer to [Appendix B](#) for details regarding phase-in and effective dates.

The agencies further note that they would retain the authority to waive these limitations and that U.S. Banking Organizations that maintain the full capital conservation buffer would still be subject to any other limitations on capital distributions that a relevant agency elects to impose under other legal authority.

Capital Conservation Buffer	Allowed Capital Distributions and Discretionary Bonus Payments
<b>Buffer &gt; 2.5%</b>	No limit imposed under the Basel III Capital NPR
<b>2.5% ≥ Buffer &gt; 1.875%</b>	Up to 60% of eligible retained income
<b>1.875% ≥ Buffer &gt; 1.25%</b>	Up to 40% of eligible retained income
<b>1.25% ≥ Buffer &gt; 0.625%</b>	Up to 20% of eligible retained income
<b>0.625% ≥ Buffer</b>	No distributions or bonus payments allowed

For purposes of calculating their respective capital conservation buffers, Advanced Approaches Banking Organizations would calculate their risk-weighted assets under the Advanced Approaches NPR, without having to calculate them against the Standardized Approach NPR floor, while all other U.S. Banking Organizations would calculate their risk-weighted assets under the Standardized Approach NPR.

**Countercyclical Capital Buffer.** Under the Basel III Capital NPR, Advanced Approaches Banking Organizations must maintain a countercyclical capital buffer of up to 2.5% of Common Equity Tier 1 capital upon a determination by the agencies that the market is experiencing excessive credit growth. When deployed, the countercyclical capital buffer would function as an extension of the capital conservation buffer. For example, if a 2.5% countercyclical capital buffer were implemented, an Advanced Approaches Banking Organization would have to hold an aggregate buffer of 5% of Common Equity Tier 1 Capital (2.5% capital conservation buffer and 2.5% countercyclical capital buffer) to avoid any restrictions on capital distributions.

The agencies do not provide details on how they would make such a determination, but note that they would do so jointly and would consider factors such as the ratio of credit to GDP, asset prices, funding spreads, indices of CDS spreads and other “measures of systemic risk.” The countercyclical capital buffer amount in the United States would initially be set to zero.

Consistent with Basel III, the agencies would generally announce the imposition of or increase in a countercyclical capital buffer 12 months prior to its effectiveness. The buffer would automatically expire 12 months after its effective date absent further agency action. A decrease would become effective the day after its announcement or the earliest date permitted by applicable law or regulation. Consistent with Basel III, the countercyclical capital buffer could first be applied in 2016, but at that point it could not be higher than 0.625% of total risk-weighted assets. The highest possible buffer would climb to 1.25% in 2017, 1.875% in 2018, and the full 2.5% in 2019.

Generally consistent with the methodology under Basel III, Advanced Approaches Banking Organizations would be required to maintain a countercyclical capital buffer equal to the average of all the countercyclical capital buffers imposed by regulatory authorities in jurisdictions in which the banking organization operates weighted by the banking organization’s private sector credit exposure located in those jurisdictions. A credit exposure would be located in a borrower’s place of incorporation (or other legal establishment) or residence. For securitization exposures, the relevant jurisdiction would be the single jurisdiction with the largest proportion of unpaid principal balance of the underlying exposures.

### Revisions to the U.S. Prompt Corrective Action Framework

Under the Basel III Capital NPR, the capital thresholds for the different PCA categories would be updated to reflect the proposed changes to the definition of capital and the regulatory capital minimum ratios. The proposed Basel III Supplementary Leverage Ratio for Advanced Approaches Banking Organizations would also be part of the revised PCA framework. The revised PCA framework would take effect starting

on January 1, 2015, consistent with the full transition of the minimum capital requirements and the calculation of risk-weighted assets under the Standardized Approach NPR.

Prompt Corrective Action Threshold	Risk-Based Capital Ratios			U.S. Leverage Ratio	Basel III Supplementary Leverage Ratio
	Total capital (unchanged)	Tier 1 capital (2015)	Common Equity Tier 1 (new in 2015)	All U.S. IDIs (unchanged)	Advanced Approaches IDIs <u>Only</u> (new in 2018)
<b>Well-Capitalized</b>	≥ 10%	≥ 8%	≥ 6.5%	≥ 5%	N/A
<b>Adequately Capitalized</b> (same as new minimum ratios under Basel III Capital NPR)	≥ 8%	≥ 6%	≥ 4.5%	≥ 4%	≥ 3%
<b>Undercapitalized</b>	< 8%	< 6%	< 4.5%	< 4%	< 3%
<b>Significantly Undercapitalized</b>	< 6%	< 4%	< 3%	< 3%	N/A
<b>Critically Undercapitalized</b>	Tangible Equity (defined as Tier 1 capital plus perpetual preferred stock) to Total Assets ≤ 2%				N/A

## Changes to Regulatory Capital (the Numerator of a Banking Organization’s Capital Ratios)

### Definition of Regulatory Capital

Consistent with Basel III, a U.S. Banking Organization’s total regulatory capital would comprise Common Equity Tier 1 capital, Additional Tier 1 capital and Tier 2 capital. These changes would apply to all U.S. Banking Organizations.

**Common Equity Tier 1 Capital.** Subject to regulatory deductions and adjustments, Common Equity Tier 1 capital would mostly include retained earnings and common stock that meets specified eligibility criteria, as well as limited amounts of minority interests in the form of common stock. This definition and associated eligibility criteria are generally consistent with Basel III. The agencies stated that most existing common stock instruments previously issued by U.S. Banking Organizations fully satisfy the proposed definition.

- **Unrealized Gains and Losses on All Available For Sale (“AFS”) Securities Reflected in Common Equity Tier 1.** Consistent with Basel III, unrealized gains and losses on *all* AFS securities would flow through to Common Equity Tier 1 capital. This would include those unrealized gains and losses related to debt securities whose valuations primarily change as a result of fluctuations in a benchmark interest rate, as opposed to changes in credit risk (e.g., U.S. Treasuries and U.S. government agency debt obligations).
- Currently, under the agencies’ general capital rules, unrealized gains and losses on AFS debt securities are not included in regulatory capital, while unrealized losses on AFS equity securities are included in Tier 1 capital and unrealized gains on AFS equity securities are partially included in Tier 2 capital. The agencies noted that their proposed change could add considerable volatility to required capital ratios and specifically sought comments on whether unrealized gains and losses on U.S. government, agency and GSE and other debt securities whose values primarily change as a result of changes in benchmark rates should be excluded from regulatory capital.



**Additional Tier 1 Capital.** Subject to regulatory deductions and adjustments, Additional Tier 1 capital would include equity capital instruments that meet specified eligibility criteria and limited amounts of minority interests. This definition and associated eligibility criteria are generally consistent with Basel III.

- Under the new eligibility criteria, non-cumulative perpetual preferred stock is generally expected to continue to qualify as Tier 1 capital. In contrast, cumulative perpetual preferred stock and trust preferred instruments would no longer qualify as Tier 1 capital. The exclusion of these instruments from the Tier 1 capital of depository institution holding companies is also consistent with the Collins Amendment.
- The agencies' proposed eligibility criteria for Additional Tier 1 capital contains the following condition relating to dividend stoppers: "The [U.S. 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 [U.S. Banking Organization] *except in relation to any capital distributions to holders of common stock.*" This is similar to the eligibility criteria for Additional Tier 1 capital in Basel III, which provides that "cancellation of distributions/payments must not impose restrictions on the bank *except in relation to distributions to common stockholders.*" However, the Basel Committee's FAQs on the definition of capital also state that "dividend stopper arrangements that stop dividend payments *on other Additional Tier 1 instruments* are not prohibited."<sup>10</sup> In contrast, the relevant rule text in the Basel III Capital NPR does not mention "other Additional Tier 1 instruments."
- While instruments classified as liabilities for accounting purposes could potentially be included in Additional Tier 1 capital under Basel III, under the Basel III Capital NPR, an instrument classified as a liability under GAAP would not qualify as Additional Tier 1 capital.

**Tier 2 Capital.** Subject to regulatory deductions and adjustments, Tier 2 capital would include capital instruments that meet specified eligibility criteria (including most traditional subordinated debt) and limited amounts of minority interests and allowances for loan and lease losses. This definition and associated eligibility criteria are generally consistent with Basel III.

- As noted previously, under the proposed eligibility criteria for Additional Tier 1 capital instruments, trust preferred securities and cumulative perpetual preferred securities would not qualify for inclusion in Additional Tier 1 capital. However, many of these instruments could qualify for inclusion in Tier 2 capital under the proposed eligibility criteria for Tier 2 capital instruments.
- As a result of the proposed new minimum Common Equity Tier 1 capital requirement, higher Tier 1 capital requirement, and the broader goal of simplifying the definition of Tier 2 capital, the Agencies proposed, consistent with Basel III, to eliminate some existing limits related to Tier 2 capital. There would be no limit on the amount of Tier 2 capital that could be included in a U.S. Banking Organization's Total capital. Existing limitations on term subordinated debt, limited-life preferred stock and trust preferred securities within Tier 2 would also be eliminated.

**Basel Committee's Loss Absorbency Criteria for Additional Tier 1 and Tier 2 Instruments.** The agencies' proposed eligibility criteria for Additional Tier 1 and Tier 2 instruments state that 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

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<sup>10</sup> The FAQs further state that dividend stopper arrangements must not "attempt to stop payment on another instrument where the payments on this other instrument were not also fully discretionary." Basel Committee, "Basel III Definition of Capital - Frequently Asked Questions" (Dec. 2011), available [here](#).

into a receivership, insolvency, liquidation, or similar proceeding. This requirement is the agencies' proposed approach to give effect to the Basel Committee's additional criteria for Additional Tier 1 and Tier 2 capital (issued in January 2011),<sup>11</sup> which were designed to ensure loss absorbency of all forms of capital at the point of non-viability, including situations in which the public sector provides support to distressed banks that would otherwise fail. Under the Basel Committee criteria, an instrument does not need to have a *contractual* write-off or conversion feature if loss absorbency at the point of non-viability can instead be met under the laws of the governing jurisdiction of the banking organization and this fact is disclosed in the offering documents. The agencies determined that U.S. law generally is consistent with the loss absorbency at point of non-viability standard, citing the Dodd-Frank Act's Title II orderly liquidation authority, Section 11 of the Federal Deposit Insurance Act and U.S. bankruptcy law provisions.

**Limited Recognition of Minority Interests.** Consistent with Basel III, minority interests in a U.S. Banking Organization's consolidated subsidiaries would be given limited recognition as part of the banking organization's Common Equity Tier 1, Additional Tier 1 capital or Tier 2 capital, depending on the nature of the subsidiary and of the interest held. Generally consistent with Basel III, the release accompanying the Basel III Capital NPR notes that only minority interests in a subsidiary of a banking organization that is a depository institution or foreign bank could be treated as Common Equity Tier 1 capital. The amount of minority interests that could be counted towards a U.S. banking organization's capital would be calculated with reference to the amount of capital held by the subsidiary and the amount of capital the subsidiary would have to hold pursuant to the capital conservation buffer.

**Transitional Arrangements for Non-Qualifying Capital Instruments.** While most of the other transitional arrangements in the Basel III Capital NPR (e.g., phasing in of minimum capital ratios and the new regulatory deductions and adjustments regime) are generally consistent with Basel III, there are some notable differences in the NPR's transitional arrangements for non-qualifying capital instruments as a result of the requirements in the Collins Amendment. Under the Collins Amendment, the phasing out from regulatory capital of non-qualifying instruments generally depends on the size of the issuing U.S. Banking Organization and the type of capital instrument involved. Please refer to **Appendix B** for details regarding transitional arrangements.

- Generally, capital instruments issued before May 19, 2010 by a depository institution holding company with \$15 billion or more in total consolidated assets as of December 31, 2009 that do not meet the proposed eligibility criteria for Additional Tier 1 or Tier 2 capital, but that were included in Tier 1 or Tier 2 capital as of May 19, 2010, would be phased out over a three-year schedule beginning in 2013. As of January 1, 2013, up to 75% of Tier 1 capital and up to 75% of Tier 2 capital could consist of capital instruments issued before May 19, 2010 that would no longer be considered Tier 1 or Tier 2 capital under the Basel III Capital NPR. The proportion of allowable non-qualifying instruments would decline annually on a *linear* basis until January 1, 2016, at which point all Tier 1 and Tier 2 capital would have to meet the new standards.
- Depository institution holding companies with less than \$15 billion in total consolidated assets and depository institutions would be allowed to benefit from a linear and more gradual phase-out schedule that would extend until January 1, 2022 with respect to capital instruments that were issued before September 12, 2010 and were outstanding as of January 1, 2013.
- The agencies proposed to permanently grandfather instruments issued by a U.S. Banking Organization under the Small Business Jobs Act of 2010 or, prior to October 4, 2010, under the Emergency Economic Stabilization Act of 2008 (e.g., TARP preferred issuances). As a result, these

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<sup>11</sup> Basel Committee, "Final Elements of the Reforms to Raise the Quality of Regulatory Capital" (Jan. 2011), available [here](#).

grandfathered instruments would be classified in the same tier of regulatory capital as they are currently classified, whether or not they meet the proposed eligibility criteria for Additional Tier 1 or Tier 2 capital. In contrast, Basel III would only grandfather public sector capital injections in banking organizations until 2018.

### **Regulatory Deductions and Adjustments**

In a manner that is generally consistent with Basel III, the agencies proposed to make extensive and detailed changes to existing regulatory deductions from and adjustments to capital. Most regulatory deductions from and adjustments to regulatory capital would be applied to Common Equity Tier 1 capital. Taken together, these proposed changes would focus bank regulatory capital on *tangible* common equity, the most loss-absorbing form of capital. Amounts deducted generally would be excluded from a banking organization's risk-weighted assets and leverage exposure. The agencies' proposed regulatory deductions and adjustments regime addresses, among other items, the following:

***Goodwill and Certain Other Intangible Assets and Certain Deferred Tax Assets (“DTAs”).*** Under the Basel III Capital NPR, goodwill<sup>12</sup> and other intangibles other than mortgage servicing assets (“MSAs”), as well as DTAs that arise from operating loss and tax credit carryforwards net of any related valuation allowances (and net of certain deferred tax liabilities (“DTLs”)), would be deducted from Common Equity Tier 1 capital. Starting in 2013, U.S. Banking Organizations would be required to deduct the full amount of goodwill (net of any associated DTLs) from Common Equity Tier 1 capital. This approach is more accelerated than Basel III, which transitions the goodwill deduction over a five-year period. DTAs arising from temporary differences that a banking organization could not realize through net operating loss carrybacks net of any related valuation allowances and net of DTLs are subject to limited recognition as Common Equity Tier 1 under the Basel III threshold deduction approach (discussed below). The Basel III Capital NPR generally provides for more limited recognition of DTAs than under the agencies' current rules.

***Gain-on-sale Associated with a Securitization Exposure.*** Any after-tax gain-on-sale associated with a securitization exposure would be deducted from Common Equity Tier 1 capital. Under the Basel III Capital NPR, gain-on-sale means an increase in the equity capital of a banking organization resulting from the consummation or issuance of a securitization (other than an increase in equity capital resulting from the banking organization's receipt of cash in connection with the securitization).

***Defined Benefit Pension Fund Assets.*** Consistent with Basel III, defined benefit pension fund assets, net of any associated DTLs, would be deducted in the calculation of Common Equity Tier 1 capital under the Basel III Capital NPR. Subject to supervisory approval, a U.S. Banking Organization would not be required to deduct defined benefit fund assets to which the banking organization has unrestricted and unfettered access. The agencies noted that because the FDIC has unfettered access to the excess assets of an IDI's pension plan in the event of receivership, an IDI generally would not need to deduct from Common Equity Tier 1 capital any assets associated with its defined benefit pension plan. Similarly, the Basel III Capital NPR would not require a depository institution holding company to deduct from capital any assets associated with a subsidiary IDI's defined benefit pension plan. Defined benefit pension fund liabilities included on the balance sheet of a U.S. Banking Organization would be fully recognized, *i.e.*, Common Equity Tier 1 capital cannot be increased via de-recognition of these liabilities.

***Changes in Own Creditworthiness and Certain Cash Flow Hedges.*** A U.S. Banking Organization would be required to deduct any unrealized gain from, and add back any unrealized loss to, Common

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<sup>12</sup> Goodwill for purposes of this deduction would include any goodwill embedded in the valuation of significant investments in the capital of an unconsolidated financial institution in the form of common stock.

Equity Tier 1 capital elements due to changes in the banking organization's own creditworthiness, consistent with Basel III. In addition, an Advanced Approaches Banking Organization would need to deduct from Common Equity Tier 1 capital any unrealized gains associated with derivative liabilities resulting from the widening of its credit spread premium over the risk-free rate. U.S. Banking Organizations would also need to exclude from Common Equity Tier 1 capital any unrealized gains and losses on cash flow hedges that relate to the hedging of items that are not recognized at fair value on the balance sheet (including projected cash flows). The agencies requested comment on whether this proposed adjustment would potentially introduce excessive volatility in regulatory capital predominantly as a result of fluctuations in a benchmark interest rate for institutions that are effectively hedged against interest rate risk.

**Capital Investments in Own Regulatory Capital Instruments.** To avoid the double-counting of regulatory capital, the Basel III Capital NPR would require a U.S. Banking Organization to deduct the amount of its investments in its own capital instruments, whether held directly or indirectly, to the extent such investments are not already de-recognized from regulatory capital. The banking organization would be required to look through its holdings of index securities to deduct investments in its own capital instruments.

**Investments in Other Financial Institutions.** Consistent with Basel III, a U.S. Banking Organization would be required to deduct direct and indirect investments in the capital of unconsolidated financial institutions that exceed certain thresholds. The banking organization would have to include indirect exposures from investments in unconsolidated entities that have exposures to the capital instruments of unconsolidated financial institutions, as well as synthetic exposures.<sup>13</sup> The agencies proposed to incorporate the Basel III corresponding deduction approach<sup>14</sup> for the deductions from regulatory capital related to (i) reciprocal cross holdings; (ii) *non-significant*<sup>15</sup> investments in the capital of unconsolidated financial institutions and (iii) *non-common stock significant* investments in the capital of unconsolidated financial institutions. Significant investments in the capital of unconsolidated financial institutions that are in the form of common stock would be subject to the Basel III threshold deduction approach (discussed below). In addition, under the Basel III Capital NPR, investments by a national bank or insured state bank in financial subsidiaries would be deducted entirely from the bank's Common Equity Tier 1 capital.

**Items Subject to the Threshold Deduction Approach.** The Basel III threshold deduction approach proposed by the agencies would provide for *limited* recognition as Common Equity Tier 1 capital of the following items, subject to a 10% individual limit and a 15% aggregate limit: (i) DTAs arising from temporary differences that could not be realized through net operating loss carrybacks (net of any related valuation allowances and net of DTLs); (ii) MSAs net of associated DTLs; and (iii) significant investments in the capital of financial institutions in the form of common stock.

- **10% Individual Limit.** The agencies proposed to require a U.S. Banking Organization to deduct from its Common Equity Tier 1 capital the above items that *individually* exceeds 10% of the banking

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<sup>13</sup> "Investment in the capital of an unconsolidated financial institution" includes direct, indirect and synthetic exposures to capital instruments, excluding underwriting positions held by the banking organization for five business days or less. An indirect exposure refers to an investment in an unconsolidated entity that has an exposure to a capital instrument of a financial institution. A synthetic exposure refers to an investment in an instrument whose value is linked to the value of a capital instrument of a financial institution.

<sup>14</sup> Generally, under the corresponding deduction approach, a banking organization would be required to make any such deductions from the same component of capital for which the underlying instrument would qualify if it were issued by the banking organization itself.

<sup>15</sup> "Non-significant investment" refers to an investment where a banking organization owns 10% or less of the issued and outstanding common shares of an unconsolidated financial institution.

organization's Common Equity Tier 1 capital, after applying certain regulatory adjustments and deductions.

- **15% Aggregate Limit.** The aggregate amount of the above items that are not deducted as a result of the 10% limit must not exceed 15% of the banking organization's Common Equity Tier 1 capital, as calculated after applying all regulatory adjustments and deductions.
- **MSAs.** Under the Federal Deposit Insurance Corporation Improvement Act, the amount of readily marketable MSAs that a banking organization may include in regulatory capital cannot be valued at more than 90% of their fair market value. Accordingly, if the amount of MSAs a banking organization deducts after the application of the threshold deduction approach is less than 10% of the fair value of its MSAs, it must deduct an additional amount of MSAs so that the total amount of MSAs deducted is at least 10% of the fair value of its MSAs.

The proposed regulatory deductions and adjustments regime would generally be phased in from January 1, 2013 until January 1, 2018, in a manner that is generally consistent with Basel III. Please refer to [Appendix B](#) for details regarding phase-in arrangements.

**Volcker Rule Capital Deductions.** The proposed regulations to implement the Volcker Rule provide for the deduction from a banking organization's Tier 1 capital of the aggregate value of investments made by the banking organization in hedge funds and private equity funds it organizes and offers pursuant to Section 13(d)(1)(G) of the Bank Holding Company Act. The agencies noted in the Basel III Capital NPR that once proposed Volcker Rule regulations are finalized, they would amend the regulatory capital treatment for investments in the capital of an unconsolidated financial institution to include the deduction that would be required under the Volcker Rule.

## Changes to Risk-Weighted Assets (the Denominator of a Banking Organization's Capital Ratios)

The three NPRs would change the way U.S. Banking Organizations calculate the denominator of their risk-based capital ratios (risk-weighted assets) while the Market Risk Final Rule will change the way Market Risk Banking Organizations calculate the market risk adjustment to the denominator.

**Background.** The denominator of a banking organization's risk-based capital ratios is its total risk-weighted assets. Very generally, this amount is calculated by assigning risk weights to a banking organization's on- and off-balance sheet exposures and aggregating those amounts. Most U.S. Banking Organizations calculate risk weights in accordance with the agencies' general capital rules (currently based on Basel I), which generally assign assets to one of four risk weight categories (zero, 20%, 50% or 100%). In addition, Market Risk Banking Organizations must supplement their total risk-weighted assets amount by adding an amount calculated under the market risk rules to reflect the risk of their trading, foreign exchange and commodity positions. As a general matter, to avoid overlap, a Market Risk Banking Organization will not include assets held for trading purposes when calculating its risk-weighted assets for the purpose of the other risk-based capital rules.

Advanced Approaches Banking Organizations calculate risk-weighted assets in accordance with the agencies' advanced approaches rules (currently based on the Basel II advanced internal ratings-based approach for credit risk and advanced measurement approaches for operational risk), which distinguish between different types of counterparty credit risk exposures, securitization exposures and equity exposures, and generally permit the use of internal risk models or supervisory formulas in calculating exposure amounts. However, as a result of the Collins Amendment capital floor, an Advanced Approaches Banking Organization must calculate its risk-based capital requirements under both the general capital rules and the advanced approaches rules (each supplemented by the market risk rules, as applicable) for purposes of determining compliance with minimum regulatory capital requirements. Accordingly, Advanced Approaches Banking Organizations will need to pay attention to all three NPRs.



## Changes to Risk-Weighted Assets for All U.S. Banking Organizations

The Standardized Approach NPR, applicable to all U.S. Banking Organizations, would amend the agencies' general capital rules to increase their risk-sensitivity. Under the Standardized Approach NPR, a U.S. Banking Organization's total risk-weighted assets would be the sum of:

- its risk-weighted assets for general credit risk, off-balance sheet items, OTC derivatives contracts, transactions cleared through central counterparties ("**CCPs**"), unsettled transactions, securitization exposures and equity exposures, plus
- its risk-weighted assets for market risk calculated under the market risk rules (as amended by the Market Risk Final Rule), if applicable, less
- the portion of its allowance for loan and lease losses that is not included in Tier 2 capital.

As compared to the general capital rules, the Standardized Approach NPR includes a greater number of exposure categories for purposes of calculating total risk-weighted assets and provides for greater recognition of credit risk mitigation techniques. The changes in the Standardized Approach NPR are proposed to take effect on January 1, 2015.

**Modified Version of Basel II Standardized Approach.** The Standardized Approach NPR generally introduces a modified version of the Basel II standardized approach, which takes into account the 2009 "Enhancements to the Basel II Framework" ("**2009 Basel II Enhancements**")<sup>16</sup> and recent consultative papers published by the Basel Committee and introduces further changes, such as the elimination of references to external credit ratings and a more granular approach to such exposures as residential mortgages. Although a number of the proposed changes in the NPR are not specifically included in the Basel II standardized approach, the agencies expressed the view that they are "generally consistent with the goals of the international framework."

**No Changes Proposed for Certain Exposures.** The treatment of exposures to the U.S. government (zero risk weight), U.S. government-sponsored entities such as Fannie Mae and Freddie Mac (20% risk weight, generally), U.S. states and municipalities (20%), U.S. IDIs (20%), most corporations and most consumer loans would remain unchanged compared to the existing general capital rules.

**Alternatives to External Credit Ratings.** Whereas Basel I<sup>17</sup> assigned uniform risk weights to many categories of exposures, the Basel II standardized approach sought to enhance the risk-sensitivity of regulatory capital rules by mapping risk weights for certain exposures (e.g., sovereign and corporate exposures) to external credit ratings. As a result of Section 939A, however, in the Standardized Approach NPR the agencies proposed to map risk weights for certain exposures to alternative standards of creditworthiness, as described below.

**Foreign Sovereign and Bank Exposures.** Under the Standardized Approach NPR, the risk weights of exposures to foreign governments, foreign public sector entities (defined as states, local authorities, or other governmental subdivisions below the level of a sovereign) and foreign banks would be based partly or wholly on the Country Risk Classification ("**CRC**") measure produced by the Organization for Economic Co-operation and Development ("**OECD**"). This methodology is largely consistent with the methodology adopted in the Market Risk Final Rule and effectively links the risk weight applicable to the entity in question to the CRC rating of the sovereign government of the entity's home country. The risk weights for these exposures range from zero to 150%, with the risk weight being set at 150% if a sovereign default

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<sup>16</sup> Basel Committee, "Enhancements to the Basel II Framework" (Jul. 2009), available [here](#).

<sup>17</sup> Basel Committee, "International Convergence of Capital Measurement and Capital Standards" (Jul. 1988, updated to Apr. 1998), available [here](#).

occurs or has occurred within the previous five years. In contrast, risk weights for exposures to and claims directly and unconditionally guaranteed by the U.S. government or its agencies receive a zero risk weight and exposures to U.S. IDIs and credit unions would continue to be risk-weighted at 20%.

**Supranational Entity and Multilateral Development Bank Exposures.** The agencies proposed to apply a zero risk weight to exposures to multilateral development banks and to the following supranational entities: the Bank for International Settlements; the European Central Bank; the European Commission; and the International Monetary Fund. In contrast, under the existing general capital rules, exposures to certain supranational entities and multilateral development banks receive a 20% risk weight.

**Corporate Exposures.** The Standardized Approach NPR leaves unchanged the uniform 100% risk weight for all corporate exposures under the agencies' general capital rules. However, unlike the existing general capital rules, exposures to securities firms would all be risk-weighted at 100%.

**Residential Mortgage Exposures.** In light of the characteristics and recent experiences of the U.S. residential mortgage market, the agencies proposed a wider range of risk weights (between 35% and 200%) based on key risk factors (*i.e.*, certain mortgage product features, resulting in two categories of residential mortgage exposures, and four bands of loan-to-value ratios). This proposed approach differs from both the existing general capital rules and the Basel II standardized framework. However, the Standardized Approach NPR would maintain the current risk-based capital treatment for residential mortgage exposures that are guaranteed by the U.S. government or a U.S. government agency. In addition, the agencies did not propose to automatically raise the risk weight for a residential mortgage exposure if it is restructured or modified. Under the existing general capital rules, a residential mortgage may be assigned to the 50% risk weight category only if it is performing in accordance with its original terms or not restructured.

**Commercial Real Estate.** The Standardized Approach NPR includes a new risk-based capital treatment for certain commercial real estate exposures that currently receive a 100% risk weight under the agencies' general capital rules. Specifically, the NPR would require U.S. Banking Organizations to assign a 150% risk weight to any High Volatility Commercial Real Estate Exposure (“HVCRE”), as defined therein. A commercial real estate loan that is not an HVCRE exposure would be treated as a corporate exposure.

**Past Due Exposures.** Consistent with the Basel II standardized approach, the agencies proposed that a banking organization assign a risk weight of 150% to an exposure that is not guaranteed or not secured (and that is not a sovereign exposure or a residential mortgage exposure) if it is 90 days or more past due or on nonaccrual.

**Equity Exposures.** The Standardized Approach NPR would establish several risk-weight categories for equity exposures based on the type of exposure and the type of issuer. Among other things, the NPR would *require* a U.S. Banking Organization to apply the simple risk-weight approach (“SRWA”) for equity exposures that are not exposures to an investment fund, with risk weights ranging from zero to 600%, and apply certain look-through approaches to assign risk-weighted asset amounts to equity exposures to an investment fund. In contrast, under the existing general capital rules, a banking organization must deduct a portion of non-financial equity investments from Tier 1 capital, based on the aggregate adjusted carrying value of all non-financial equity investments held directly or indirectly by the banking organization as a percentage of its Tier 1 capital; and for those equity exposures that are not deducted, a banking organization generally must assign a 100% risk weight.

**Off-Balance Sheet Items.** The Standardized Approach NPR retains the general approach of calculating the exposure amount of an off-balance sheet item by multiplying the off-balance sheet component, which is usually the notional amount, by the applicable credit conversion factor (“CCF”). However, the NPR would broaden the type of off-balance sheet items subject to regulatory capital and also increase the CCF for certain off-balance sheet items. According to the agencies, the proposed capital treatment for off-balance sheet items is consistent with Section 165(k) of the Dodd-Frank Act, which provides that the

regulatory capital calculations for a BHC with \$50 billion or more in total assets must take into account off-balance sheet activities.

**OTC Derivatives.** The proposed revisions to the treatment of OTC derivative contracts in the Standardized Approach NPR include, among other things, an updated definition of an OTC derivative contract, a revised conversion factor matrix for calculating the potential future exposure (“PFE”), a revision of the criteria for recognizing the netting benefits of qualifying master netting agreements and of financial collateral and the removal of the existing general capital rules’ 50% risk weight limit for OTC derivative contracts.

**Cleared Derivatives and “Repo-Style Transactions.”** The proposed capital treatment for cleared derivatives and repo, reverse repo and securities lending and borrowing transactions meeting a set of criteria is broadly consistent with the Basel Committee’s 2011 consultative document regarding capitalization of banking organization exposures to CCPs<sup>18</sup> which applies different approaches to calculating risk-weighted exposure amounts depending on whether the CCP is a qualifying CCP, whether a banking organization is acting as a clearing member or a client of a clearing member and whether the exposure is a trading exposure or a clearing member’s contribution to the CCP’s default fund. The trading exposures to qualifying CCPs (CCPs that meet regulatory and other eligibility criteria) are risk weighted at 2% for banking organizations acting as clearing members and at either 2% or 4% for banking organizations that are clearing member clients, depending on whether the arrangements for the collateral posted by the banking organizations meet certain requirements. Default fund contributions to qualifying CCPs are risk-weighted based on a supervisory formula which is dependent on the qualifying CCP’s hypothetical capital requirement and the extent to which that requirement has been fully funded or the clearing members may be subject to additional capital assessments.

**Unsettled Transactions.** The agencies’ proposed methodology for calculating the risk-weighted asset amounts for transactions involving securities, foreign exchange instruments and commodities that have a risk of delayed settlement or delivery distinguishes between delivery-versus-payment (“DvP”) and payment-versus-payment (“PvP”) transactions, on the one hand, and non-DvP or non-PvP transactions, on the other. Generally, the Standardized Approach NPR would require a U.S. Banking Organization to hold capital against a DvP or PvP transaction with a normal settlement period if the banking organization’s counterparty has not made delivery or payment within five business days after the settlement date.<sup>19</sup> A U.S. banking organization would be required to hold capital against any non-DvP or non-PvP transaction with a normal settlement period if it delivered cash, securities, commodities, or currencies to its counterparty but has not received its corresponding deliverables by the end of the same business day, and must continue to hold capital against the transaction until it has received such deliverables.<sup>20</sup>

**Securitization Exposures.** Under the Standardized Approach NPR, a U.S. Banking Organization would generally determine the risk-based capital requirement for securitization exposures by applying either:

- if the banking organization is not subject to the Market Risk Final Rule, a gross-up approach (similar to that in the existing general capital rules) based on the level of subordination of a securitization

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<sup>18</sup> Basel Committee, “Capitalisation of Bank Exposures to Central Counterparties” (Nov. 2011), available [here](#).

<sup>19</sup> The risk-weighted asset amount for such a transaction would be determined by multiplying the positive current exposure of the transaction for the banking organization by the applicable risk weight, which ranges from 100% to 1,250% depending on the number of business days that has elapsed since the contractual settlement date.

<sup>20</sup> If it has not received the deliverables by the fifth business day after the counterparty delivery due date, the banking organization must assign a 1,250% risk weight to the current market value of the deliverables owed.

exposure and assigns capital requirements based on the full amount of the credit-enhanced assets for which the banking organization directly or indirectly assumes credit risk; or

- a simplified supervisory formula approach (“**SSFA**”), which is a simplified version of the current supervisory formula approach (“**SFA**”) in the agencies’ current advanced approaches rules. The SSFA was developed as an alternative to credit ratings and would generally result in relatively higher capital requirements for the more junior tranches of a securitization and relatively lower capital requirements for the most senior positions. The SSFA methodology is also proposed in the Advanced Approaches NPR and is included in the Market Risk Final Rule.

In either case, the minimum risk weight for a securitization exposure would be 20%. A U.S. Banking Organization would be required to apply either the gross-up approach or the SSFA consistently to all of its securitization exposures. With certain exceptions related to asset-backed commercial paper, any securitization exposure to which a banking organization applies neither the gross-up approach nor the SSFA would be assigned a risk weight of 1,250% (*i.e.*, a capital charge equal to the full amount of the exposure, based on a minimum total risk-based capital ratio of 8%).

**Credit Risk Mitigation.** The agencies’ proposed approach to credit risk mitigation is largely similar to the Basel II standardized approach, which recognizes a broader range of credit risk mitigation techniques than Basel I and generally adopts a more sophisticated approach for taking into account such techniques in quantifying a banking organization’s credit risk. Among other things, the proposed revisions in the Standardized Approach NPR would result in a greater recognition of financial collateral and a wider range of eligible guarantors.

- **Financial Collateral.** As proposed, financial collateral would include collateral in the form of: (i) cash on deposit with the banking organization (including cash held for the banking organization by a third-party custodian or trustee); (ii) gold bullion; (iii) short- and long-term debt securities that are not resecuritization exposures and that are investment grade; (iv) equity securities that are publicly traded; (v) convertible bonds that are publicly traded; or (vi) money market fund shares and other mutual fund shares if a price for the shares is publicly quoted daily. With the exception of cash on deposit, the banking organization would also be required to have a perfected, first-priority security interest or, outside of the United States, the legal equivalent thereof, notwithstanding the prior security interest of any custodial agent.
- **Meaning of “Investment Grade.”** The agencies proposed to use an “investment grade” standard that does not rely on credit ratings in the Standardized Approach NPR and the Advanced Approaches NPR. This definition, which relies upon qualitative assessments by a banking organization, is also adopted in the Market Risk Final Rule and is consistent with the standard contained in the OCC’s “Alternatives to the Use of External Credit Ratings” NPR in 2011.<sup>21</sup> Generally, “investment grade” means that the entity to which a 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. Such an

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<sup>21</sup> Under the OCC’s proposal, when determining whether a particular issuer has an adequate capacity to meet financial commitments under a security for the projected life of the security, a national bank would be required to consider a number of factors, which may include external credit ratings, internal risk ratings, default statistics and other sources of information as appropriate for the particular security. While external credit ratings and assessments would remain a source of information and provide a national bank with a standardized credit risk indicator, it would be expected to supplement this information with due diligence processes and analyses appropriate for the bank’s risk profile and for the size and complexity of the debt instrument. Accordingly, it would be possible that a security rated in the top four rating categories by a credit rating agency may not satisfy the proposed revised investment grade standard. See OCC, “Alternatives to the Use of External Credit Ratings,” 76 Fed. Reg. 73,526 (Nov. 29, 2011), available [here](#).

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.

**Disclosure Requirements for Certain Large U.S. Banking Organizations.** The Standardized NPR subjects top-tier banking organizations domiciled in the United States with \$50 billion or more in total consolidated assets that are *not* Advanced Approaches Banking Organizations to qualitative and quantitative disclosure requirements related to regulatory capital, which are broadly consistent with the disclosure requirements in Basel III<sup>22</sup>. The proposed disclosure requirements include qualitative disclosures (e.g., descriptions of a banking organization's policies and procedures for assessing its capital adequacy and for managing risks associated with its assets) and quantitative disclosures (e.g., amount of each category of regulatory capital the banking organization holds and its aggregate risk-weighted asset amount for various categories of assets). According to the agencies, the timing of their proposed disclosures takes into account the timing of disclosures required under the federal securities laws. The agencies proposed that if a U.S. Banking Organization believes that disclosure of specific commercial or financial information would compromise its position by making public information that is either proprietary or confidential in nature, it need not disclose those specific items. Instead, the banking organization must disclose more general information about the subject matter of the requirement, together with the fact that, and the reason why, the specific items of information have not been disclosed.

#### **Changes to Risk-Weighted Assets for Advanced Approaches Banking Organizations**

The Advanced Approaches NPR would revise the agencies' existing Basel II advanced approaches rules. The proposed revisions would incorporate aspects of Basel III and other revisions to the Basel capital framework made by the Basel Committee in a series of documents between 2009 and 2011 and subsequent consultative papers, including the 2009 Basel II Enhancements. The primary focus of the revisions is on counterparty credit risk and the securitization exposure framework.

**Scope of Application.** The Advanced Approaches NPR would apply to Advanced Approaches Banking Organizations, *i.e.*, those U.S. Banking Organizations with \$250 billion or more in consolidated total assets or \$10 billion or more in consolidated total on-balance sheet foreign exposure. Please refer to **Table 1** above for details regarding the scope of application of the new rules.

**Counterparty Credit Risk.** The Advanced Approaches NPR would revise the counterparty credit risk framework in the agencies' advanced approaches rules in a manner broadly consistent with Basel III, modified to incorporate alternatives to external credit ratings.

- **Changing the Internal Models Methodology ("IMM") to Incorporate Stressed Inputs.** Generally consistent with Basel III, the agencies proposed to amend the advanced approaches rule so that the capital requirement for IMM exposures (repo-style transactions, eligible margin loans and OTC derivatives for which Exposure at Default ("EAD") is calculated using the IMM) would be equal to the larger of the capital requirement for those exposures calculated using (i) data from the most recent three-year period; and (ii) data from a three-year period that contains a period of stress reflected in the credit default spreads of the banking organization's counterparties. The agencies also proposed to require Advanced Approaches Banking Organizations to subject their internal models to an initial validation and annual model review process.

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<sup>22</sup> In December 2011, the Basel Committee proposed additional Pillar 3 disclosure requirements in a consultative paper entitled "Definition of Capital Disclosure Requirements." Once the Basel Committee finalizes these additional disclosure requirements, the agencies stated that they anticipate applying them to U.S. Banking Organizations with more than \$50 billion in total assets through a separate rulemaking. Basel Committee, "Definition of Capital Disclosure Requirements" (Consultative Document) (Dec. 2011), available [here](#).



- **Recognition of Wrong-Way Risk.** Generally consistent with Basel III, the Advanced Approaches NPR would define wrong-way risk as the risk that arises when an exposure to a particular counterparty is positively correlated with the probability of default of the counterparty itself. The agencies also proposed enhancements to the advanced approaches rules that would require banking organizations' risk management procedures to identify, monitor, and control wrong-way risk throughout the life of an exposure.
- **Increased Asset Value Correlation Factor.** To recognize the high correlation of financial institutions' creditworthiness owing to sensitivity to common risk factors, the Advanced Approaches NPR would, consistent with Basel III, increase capital requirements for exposures to non-regulated financial institutions and to regulated financial institutions with consolidated assets of \$100 billion or more. The enhanced requirement would be implemented by requiring Advanced Approaches Banking Organizations to apply a multiplier of 1.25 to a correlation factor for wholesale exposures to such institutions.
- **Credit Valuation Adjustments ("CVAs").** The Advanced Approaches NPR includes a higher counterparty credit risk capital requirement, generally consistent with Basel III, to account for CVA risk. CVA is the fair value adjustment that reflects counterparty credit risk in the valuation of an OTC derivative contract. The requirement is calculated based on a supervisory formula, or the Advanced CVA Approach, based on an adjustment to a banking organization's other VaR models for specific risk. The Advanced CVA Approach may be used only by an Advanced Approaches Banking Organization that is subject to the Market Risk Final Rule and has received the approval of its primary federal supervisor.
- **Revisions to the Recognition of Financial Collateral.** Generally consistent with Basel III, the agencies proposed to modify the definition of financial collateral so that resecuritizations, conforming residential mortgages and non-investment grade debt (using the same qualitative definition of "investment grade" as discussed above) would no longer qualify as financial collateral for purposes of adjusting a banking organization's EAD to a counterparty to recognize the credit risk mitigation benefits of financial collateral.
- **Changes to Holding Periods and the Margin Period of Risk.** Generally consistent with Basel III, the agencies proposed to amend the advanced approaches rules to incorporate increases to the assumed holding period in the collateral haircut and simple VaR approaches, and to the margin period of risk in the IMM that a banking organization may use to determine its capital requirement for repo-style transactions, OTC derivative transactions, or eligible margin loans.
- **Centrally Cleared Transactions.** Generally consistent with the above-mentioned Basel Committee's consultative paper on capitalization of bank exposures to CCPs and the Standardized Approach NPR, the Advanced Approaches NPR would introduce advanced approaches capital requirements for cleared transactions with CCPs and for default fund contributions to CCPs by clearing member banking organizations. The applicable risk weights for exposures to CCPs generally depend on whether the CCP is a qualifying CCP and a number of other factors.

**Treatment of Securitization Exposures.** Broadly consistent with the 2009 Basel II Enhancements, the agencies proposed to strengthen the risk-based capital requirements for certain securitization exposures by requiring Advanced Approaches Banking Organizations to conduct more rigorous credit analysis of securitization exposures and enhancing the disclosure requirements related to these exposures. Consistent with Section 939A, the Advanced Approaches NPR would remove the ratings-based and the internal assessment approaches for securitization exposures from the agencies' current advanced approaches rules. They would be replaced by the use of either the SFA or a simplified version of the SFA, the SSFA, for an Advanced Approaches Banking Organization to calculate its capital requirement for securitization exposures. This aspect of the Advanced Approaches NPR addresses, among other things:

- the definitions of securitization (including traditional securitizations and synthetic securitizations) and resecuritization;
- operational criteria for recognizing risk transference in traditional securitizations;
- revisions to the hierarchy of approaches for deductions or risk weights relating to securitization exposures;
- risk-based capital requirements for guarantees and credit derivatives referencing a securitization exposure;
- due diligence requirements for securitization exposures; and
- risk-weighting nth-to-default credit derivatives used to provide or obtain credit protection on underlying exposures.

**Removal of External Credit Ratings.** Consistent with Section 939A, the agencies proposed a number of changes to the definitions in the advanced approaches rules that currently reference external credit ratings. These changes are broadly similar to alternative standards proposed in the Standardized Approach NPR and alternative standards that already have been implemented in the agencies' Market Risk Final Rule. In addition, the agencies proposed necessary changes to the hierarchy for risk-weighting securitization exposures necessitated by the removal of the external credit ratings.

**Disclosure Requirements.** The agencies proposed to require an Advanced Approaches Banking Organization to provide enhanced disclosures with respect to securitizations.

### Changes to Risk-Weighted Assets for Market Risk Banking Organizations

The Market Risk Final Rule amends the agencies' market risk rules, which apply to Market Risk Banking Organizations—*i.e.*, U.S. Banking Organizations that have aggregated trading assets and liabilities of at least \$1 billion or 10% of total assets. Among other things, the Market Risk Final Rule:

- implements enhancements to the market risk capital standards developed by the Basel Committee (Basel 2.5), other than aspects that require the use of external credit ratings, consistent with Section 939A;
- imposes additional prudential requirements on internal models for measuring capital requirements;
- strengthens non-modeled capital requirements for market risk; and
- requires enhanced qualitative and quantitative disclosures.

Although some commenters, in response to the agencies' 2011 market risk proposal, expressed a concern that aspects of the amendments may result in duplicative, and thus excessive, capital requirements, the agencies have expressed the view that the rules provide a "prudent level of conservatism" to address factors such as modeling uncertainties.

**Effective Date and Scope of Application.** The Market Risk Final Rule will be effective on January 1, 2013. As noted above, the agencies also proposed, in the Advanced Approaches NPR, to apply the market risk rules to any top-tier savings and loan holding company domiciled in the United States and savings association whose trading assets and liabilities are equal to 10% or more of its total assets or \$1 billion or more. Please see [Table 1](#) above for details regarding the scope of application of the new rules.

**Calculation of Market Risk Equivalent Assets.** The Market Risk Final Rule requires any Market Risk Banking Organization to calculate its risk-based capital ratio denominator as the sum of (i) its adjusted risk-weighted assets, calculated in accordance with the risk-based capital rules, and (ii) its market risk equivalent assets, calculated in accordance with the market risk rules.

An Advanced Approaches Banking Organization is required to calculate both a general risk-based capital ratio denominator (under the general capital rules) and an advanced risk-based capital ratio denominator (under the advanced approaches rules), supplemented in each case by the market risk rules (if applicable). As a result, a Market Risk Banking Organization that is also an Advanced Approaches Banking Organization must calculate two market risk equivalent asset amounts: a general measure for market risk and an advanced measure for market risk.

In either case, the measure for market risk is equal to the sum of the banking organization's VaR-based capital requirement, stressed VaR-based capital requirement, specific risk add-ons, incremental risk capital requirement, comprehensive risk capital requirement and capital requirement for *de minimis* exposures. The components of the two measures for market risk are the same, except that a banking organization may not use the SFA for securitization positions to calculate its general measure for market risk, whereas it must use the SFA for securitization positions to calculate its advanced measure for market risk.

Each of these measures for market risk is then multiplied by 12.5 to produce, respectively, general market risk equivalent assets for purposes of the Advanced Approaches Banking Organization's general risk-based capital ratio denominator and advanced market risk equivalent assets for purposes of its advanced risk-based capital ratio denominator. This permits an Advanced Approaches Banking Organization to determine compliance with its minimum regulatory capital requirements, which are the higher of its minimum general risk-based capital requirements and its minimum advanced approaches risk-based capital requirements.

**Covered Positions.** The Market Risk Final Rule applies to all "covered positions." Whereas the current market risk rules define covered position to include all positions in a Market Risk Banking Organization's trading account, regardless of whether they are held with the intent to trade, the Market Risk Final Rule modifies the definition of covered position to focus on whether the position is held with the intent to trade. Covered positions include:

- trading assets or trading liabilities (as reported in a bank's Call Report or a BHC's Consolidated Financial Statements) that: (i) are "trading positions" or hedge trading positions; and (ii) are free of any restrictive covenants on their tradability or the material risk elements of which can be hedged by the bank in a two-way market; and
- foreign exchange and commodity positions, regardless of whether they are trading assets or liabilities.

In response to comments received, the agencies modified the definition of "two-way market" to provide more flexibility to account for variations in market settlement practices.

The term "trading positions" is defined to mean positions that are held for the purpose of short-term resale, to lock in arbitrage profits, to benefit from actual or expected short-term price movements, or to hedge covered positions. As a result, certain less liquid and difficult to value positions, and positions not held with the ability to trade (other than hedges of positions that qualify as covered positions) will be subject to the agencies' general capital rules and the advanced approaches rules, as applicable, rather than the market risk rules. The definition of "trading position" corresponds with the definition of "trading account" in the Volcker Rule. As a result, the restrictions on proprietary trading in the Volcker Rule would apply to all covered positions that are trading positions under the market risk capital rules, subject to the Volcker Rule's exceptions.

The definition of covered position is subject to certain exclusions, such as hedges of trading positions that are outside of a Market Risk Banking Organization's hedging strategy. Market Risk Banking Organizations must have clearly defined trading and hedging strategies for their trading positions that are approved by senior management.

**VaR and Stressed VaR.** Consistent with the agencies' proposal, a Market Risk Banking Organization must use one or more internal models to calculate a daily VaR-based measure of the market risk for all covered positions and must use those same internal models to calculate a stressed VaR-based measure on at least a weekly basis. The rules also provide that the daily VaR-based measure may reflect the specific risk of certain covered positions.

Consistent with the current market risk rules, the Market Risk Final Rule requires that a Market Risk Banking Organization integrate its internal models into its risk management processes. A Market Risk Banking Organization is also required to notify its primary federal supervisor of any material changes in its models and comply with new requirements for monitoring and backtesting (*i.e.*, comparing the banking organization's internal estimates with actual outcomes during a sample period not used in the development of the model) and update its VaR-based and stressed VaR-based measures as appropriate. The Market Risk Final Rule extends the date by which Market Risk Banking Organizations must comply with the new backtesting requirement to the later of January 1, 2014 and one year after the date on which a banking organization becomes subject to the market risk rules.

**Specific Risk.** Specific risk is the risk of loss on a position that could result from factors other than broad market movements and includes event and default risk as well as idiosyncratic risk. A Market Risk Banking Organization must have policies and procedures to determine whether a position has specific risk and must measure the specific risk for each of its debt, equity and securitization positions. A banking organization must use internal models to measure the specific risk of certain "correlation trading positions" and may use internal models to measure the specific risk of certain other covered positions. The rules prohibit Market Risk Banking Organizations from modeling specific risk for securitization positions, other than correlation trading positions, and instead requires them to use the standardized approach for such positions, as described below.

A Market Risk Banking Organization that does not have an approved internal model that captures all material aspects of the specific risk for a particular portfolio must use the standardized method to calculate specific risk capital requirements. The standardized approach incorporates alternative standards of creditworthiness that do not reference external credit ratings. In certain cases, and consistent with the Standardized Approach NPR, the methodology relies on CRCs published by the OECD, despite strong criticism from commenters. The alternative standards for standardized specific risk are as follows:

**Sovereign Debt Positions.** Broadly consistent with the proposed methodology for sovereign exposures in the Standardized Approach NPR, the Market Risk Final Rule determines the specific risk capital requirement for sovereign debt positions based on the CRC published by the OECD, subject to the following exceptions:

- Exposures to the U.S. government and its agencies will be deemed to have a CRC that results in a standardized specific risk capital requirement of zero.
- An exposure to a sovereign that has defaulted during the previous five years will result in a greater default risk-weighting factor. The agencies revised the definition of default by a sovereign entity from that which was proposed in the proposal. Under the final rules, default by a sovereign entity means noncompliance by the sovereign entity with its external debt service obligations or the inability or unwillingness of a sovereign entity to service an existing obligation according to its original contractual terms, as evidenced by the failure to pay principal and interest timely and fully, arrearages, or restructuring.
- A lower specific risk-weighting may be assigned if: the position is denominated in the sovereign entity's currency; the Market Risk Banking Organization has at least an equivalent amount of liabilities in that currency; and the sovereign entity allows banks under its jurisdiction to assign the lower specific risk-weighting factor to the same exposures to the sovereign entity.

- If a sovereign does not have a CRC assigned to it, a risk-weighting factor of 8% must be used, unless the sovereign is in default.

**Supranational Entity and Multilateral Development Bank Debt Positions.** A Market Risk Banking Organization may assign a specific risk-weighting factor of zero to debt positions that are exposures to certain supranational entities and multilateral development banks.

**Government-Sponsored Entity Exposure.** Consistent with the proposed rules, GSE equity exposures, including preferred stock, and debt exposures will receive specific risk-weighting factors of 8% and 1.6%, respectively.

**Public Sector Entity, Depository Institution, Foreign Bank, and Credit Union Debt Positions.** The specific risk capital requirement for public sector entities, depository institutions, foreign banks, and credit union debt positions also incorporates the use of CRCs. A Market Risk Banking Organization must use the CRC of an entity's sovereign of incorporation and the remaining contractual maturity of the position, and apply a capital requirement that is one step higher than that applied to the entity's sovereign of incorporation. Exposures to certain non-U.S. entities will be subject to higher capital requirements than they are currently due to the fact that the current treatment of exposures to such non-U.S. entities is based on whether the entity's sovereign of incorporation is an OECD member.

**Corporate Debt Positions.** The agencies abandoned the proposed indicator-based approach for publicly traded corporate debt positions in favor of an alternative "investment grade" approach, as discussed above.

**Securitization Positions.** The agencies substantially revised the securitization section of the rules. First, Advanced Approaches Banking Organizations that are Market Risk Banking Organizations and meet certain criteria must use the SFA in the agencies' advanced approaches rules to calculate specific risk-weighting factors for securitization positions, rather than the SSFA under the Market Risk Final Rule. Second, if the Market Risk Banking Organization or the securitization position does not qualify for the SFA, the banking organization may assign a specific risk-weighting factor to the securitization position using the SSFA or assign a 100% specific risk-weighting factor to the position. With respect to the SSFA, the Market Risk Final Rule requires Market Risk Banking Organizations to use a formula that takes into account significant delinquencies on underlying assets, rather than impose the proposed "flexible floor" that would have raised capital requirements on securitization positions in response to increased cumulative losses on the underlying assets of a securitization. Under the Market Risk Final Rule, the base capital requirement of the underlying exposures may never be lower than the weighted-average capital requirement of the underlying exposures under the general capital rules. The SSFA is also included in the Standardized Approach NPR and the Advanced Approaches NPR.

**Incremental Risk Capital Requirement.** A Market Risk Banking Organization that uses an internal model to measure the specific risk of a portfolio of debt positions, and, subject to approval and certain conditions, equity positions, must calculate an incremental risk measure (*i.e.*, a measure of a position's default risk and credit migration risk) at least weekly to address risks not adequately calculated in the VaR-based measure. Consistent with the Basel Committee standards, the incremental risk measure must be calculated over a one-year time horizon and at a one-tail, 99.9% confidence level, under assumptions of either a constant level of risk or constant positions, using a minimum default liquidity horizon of the lower of three months and the contractual maturity of the position. This default horizon was criticized by commenters for being too long for certain highly liquid exposures.

**Comprehensive Risk Capital Requirement.** A Market Risk Banking Organization is permitted under the Market Risk Final Rule to use internal models to measure all material price risk (*i.e.*, comprehensive risk) for one or more portfolios of correlation trading positions. A Market Risk Banking Organization that relies on the comprehensive risk model will be subject to an 8% (down from the proposed 15%) surcharge in addition to the modeled capital requirement until such time as the model has been approved by its primary federal supervisor and the banking organization has met relevant requirements for at least



one year. Once the model is approved and all relevant requirements have been met, a Market Risk Banking Organization may use the floor approach, where capital requirements are the greater of the capital calculated using the comprehensive risk model or 8% of the total standardized specific risk capital requirement for correlation trading positions. If a Market Risk Banking Organization does not use a comprehensive risk model, then it must calculate a specific risk add-on for its correlation trading position portfolio in accordance with the standardized measurement method.

**Disclosures.** In addition to the above-described capital requirements, the Market Risk Final Rule requires Market Risk Banking Organizations to comply with enhanced quantitative and qualitative disclosure requirements that cover, among other things, components of their market risk capital requirement and modeling approaches. The final rule is consistent with the proposed rule, except it does not require Market Risk Banking Organizations to disclose the median value for various risk measures. The final rule also provides that a Market Risk Banking Organization can withhold from disclosure any information that is proprietary or confidential if the banking organization believes that the disclosure of the information would seriously prejudice its position.

**Future Rulemaking and Potential Alignment with Basel Committee Developments.** Federal Reserve Governor Daniel K. Tarullo stated at the Federal Reserve Board's open meeting to consider the NPRs and the Market Risk Final Rule that the agencies may revise the Market Risk Final Rule at a later date and explore possible standardized capital requirements for market risk as a back-up for model-derived risk weights. Such an approach would be more aligned with the Basel Committee's May 2012 consultative document on the fundamental review of market risk capital requirements. Among other things, the consultative document would move from VaR to an "expected shortfall" measure in order to better capture "tail risk," include a more granular model approval process and constraints on diversification, and require mandatory calculation of the standardized approach by all Market Risk Banking Organizations, including those that currently use model-based approaches, with the possibility of introducing the standardized approach as a floor or surcharge to those Market Risk Banking Organizations using internal models.

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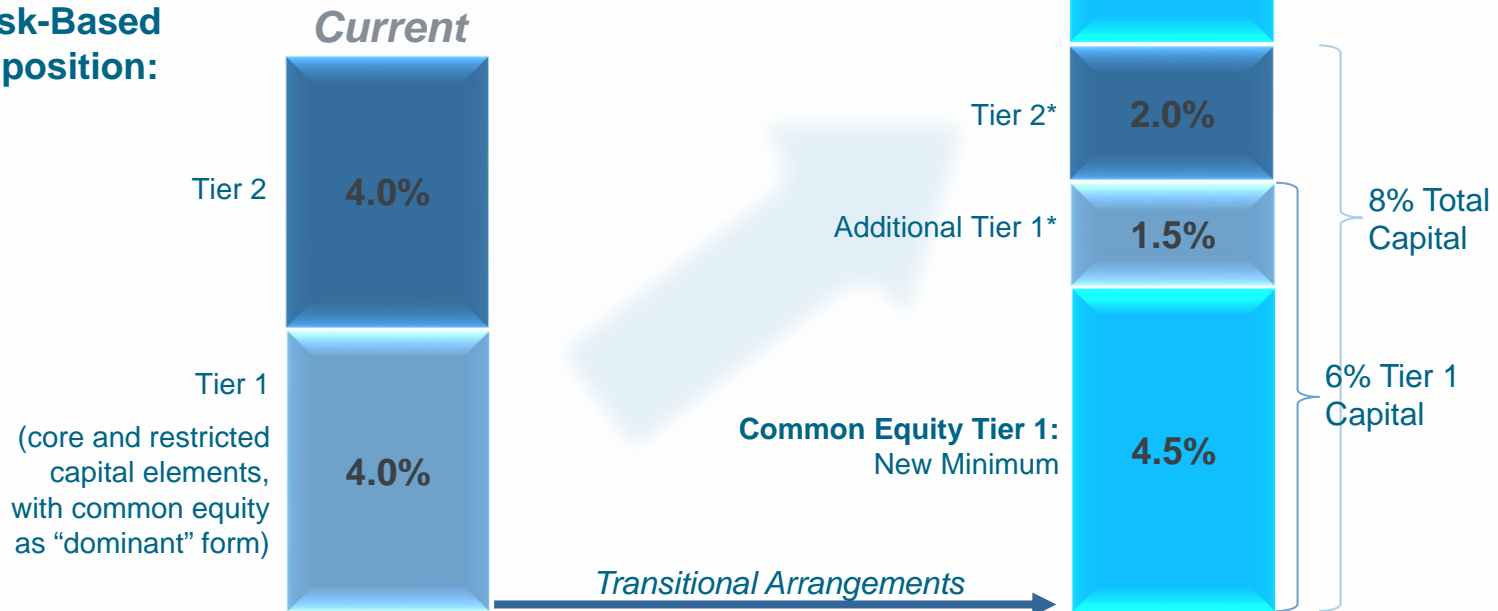
# Appendix A Proposed Minimum Capital Requirements

## Leverage Capital Requirements

**U.S. Leverage Ratio** (Tier 1 capital to average total consolidated assets must be at least **4%**). Applies to all U.S. Banking Organizations.

**Basel III Supplementary Leverage Ratio** (Tier 1 capital to “total leverage exposure” must be at least **3%**). Applies only to Advanced Approaches Banking Organizations.

## Minimum Risk-Based Capital Composition:



\* The proposed rules would not require a U.S. Banking Organization to hold a minimum amount of Additional Tier 1 or Tier 2 capital. Whereas the amount of Tier 2 capital is currently limited to 100% of Tier 1 capital, under the proposed rules there is no limit on the amount of Tier 2 capital a U.S. Banking Organization can hold.

## Appendix B Key Effective Dates and Transitional Arrangements in Proposed and Final Revisions to U.S. Bank Capital Framework

All dates refer to January 1, except where noted.

Phase-in period for minimum risk-based capital ratios				
	Current	2013	2014	2015
Common Equity Tier 1	N/A	3.5%	4.0%	4.5%
Tier 1 capital	4.0%	4.5%	5.5%	6.0%
Total capital	8.0%	8.0%	8.0%	8.0%

**January 1, 2015:** Effective Date of Standardized Approach NPR and Revised Prompt Corrective Action Framework

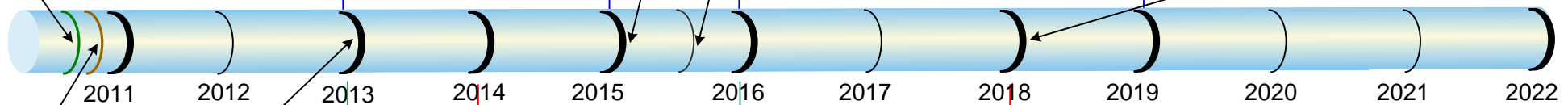
**July 21, 2015:** SR 01-1 BHCs become subject to U.S. capital rules

Phase-in period for capital conservation buffer				
	2016	2017	2018	2019
Buffer (Common Equity Tier 1)	0.625%	1.25%	1.875%	2.5%
Buffer + Minimum Common Equity Tier 1	5.125%	5.75%	6.375%	7.0%
Buffer + Minimum Total Capital	8.625%	9.25%	9.875%	10.5%

**May 19, 2010:** Phase-out eligibility cut-off date for certain U.S. Banking Organizations

**Sept. 12, 2010:** Phase-out eligibility cut-off date for certain U.S. Banking Organizations

**January 1, 2018:** Basel III Leverage Ratio for Advanced Approaches Banking Organizations



**January 1, 2013:** Effective Date of Market Risk Final Rule

Capital instruments issued by Advanced Approaches Banking Organizations after January 1, 2013 must include **loss-absorbency disclosure**.

Phase-out of non-qualifying instruments issued before May 19, 2010 by ≥ \$15 billion depository institution holding companies				
	2013	2014	2015	2016
% included in Additional Tier 1 or Tier 2 capital	75%	50%	25%	0%

General phase-in period for new regulatory deductions and adjustments regime					
2013	2014	2015	2016	2017	2018
0%	20%	40%	60%	80%	100%

**Permanent grandfathering** of non-qualifying instruments issued under the Small Business Jobs Act or, prior to October 4, 2010, under the Emergency Economic Stabilization Act of 2008 (e.g., TARP preferred issuances).

Phase-out of non-qualifying instruments issued before September 12, 2010 by depository institutions and < \$15 billion depository institution holding companies										
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
% included in Additional Tier 1 or Tier 2 capital	90%	80%	70%	60%	50%	40%	30%	20%	10%	0%