

## Bank Capital Rules

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### Federal Reserve Approves NPRs Addressing Basel III Implementation and Substantial Revisions to Basel I-Based Rules for all Banks and Finalizes Amendments to Market Risk Rules

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#### SUMMARY

Yesterday afternoon, the Board of Governors of the Federal Reserve System (the “FRB”) approved for publication three notices of proposed rulemaking (the “NPRs”) substantially amending the risk-based capital rules for banks.<sup>1</sup> The FRB also approved final amendments to the market risk rules (the “Market Risk Amendments”), often referred to as “Basel II.5”.<sup>2</sup> The NPRs and Market Risk Amendments are meant to be joint rulemakings with the Office of the Comptroller of the Currency (the “OCC”) and the Federal Deposit Insurance Corporation (the “FDIC”) and, together with the OCC and the Federal Reserve the “Agencies”) and will be published in the Federal Register after approval by the OCC and the FDIC, which is expected during the next several weeks.

The changes to the Agencies’ capital rules proposed in the NPRs and finalized in the Market Risk Amendments when implemented, taken together, will represent the most substantial revisions to the Agencies’ capital rules since the adoption in 1989 of risk-based capital standards based on the Basel Committee on Banking Supervision’s (“BCBS”) 1988 Accord, known as “Basel I”. Among other things:

- Most of the Basel III<sup>3</sup> provisions, including the application of a common equity Tier 1 (“CET1”) requirement, the revised definitions of other components of capital, and higher minimum capital ratios, would apply to all banks other than small bank holding companies (defined as those with \$500 million or less in total assets), with phase-in periods that generally track Basel III. It remains to be seen whether the Agencies will actually follow these and other phase-in periods or will, as in the past, effectively accelerate them through restrictions on capital actions and expansion applications until the bank is fully compliant.
- The standards in the Agencies’ existing Basel I-based capital rules, which the NPRs refer to as the “general risk-based capital requirements”, would be revised, effective January 1, 2015, to include a more risk sensitive risk-weighting approach based, in part, upon Basel II’s<sup>4</sup> standardized approach, expanding the risk-weighting categories from the current four categories (0%, 20%, 50% and 100%) to a much larger and more risk-sensitive number of categories, depending on the nature of the assets, generally ranging from 0% for U.S. government securities, to 600% for certain equity exposures, and resulting in higher risk weights for a variety of asset categories, including many

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residential mortgages and certain commercial real estate. The NPRs refer to the general risk-based capital requirements as amended by the NPRs as the new “*Standardized Approach*”.

- The Standardized Approach and the Market Risk Amendments would implement the requirement of Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“*Dodd-Frank*”) that regulations not use credit ratings by, where applicable, (i) for determining the risk weight of certain exposures to non-U.S. sovereigns and non-U.S. public sector entities, using the Organization for Economic Co-operation and Development’s (the “*OECD*”) country risk classification model (or “*CRCs*”), and (ii) for determining the risk weight of corporate exposures, adopting a definition of “*investment grade*” that is based on an approach that the OCC implemented in its investment securities regulations; namely, treating an exposure as investment grade if the obligor “has adequate capacity to meet financial commitments for the projected life of the asset or exposure”, with the “adequate capacity” test being met if “the risk of [the obligor’s] default is low and the full and timely repayment of principal and interest is expected”.
- The FRB would apply capital rules to savings and loan holding companies when these proposed rules become effective as opposed to the July 22, 2015 outside date permitted by Section 171 of Dodd-Frank (the “*Collins Amendment*”).

The text of the NPRs and Market Risk Amendments, together with explanatory staff memos and preambles, is quite lengthy, running to more than 800 pages. We anticipate preparing more detailed memoranda to clients addressing them in the coming days. This memorandum serves only to highlight certain key features of the NPRs and the Market Risk Amendments.

The comment periods for each of the NPRs expire on September 7, 2012. The Market Risk Amendments become effective on January 1, 2013, and the NPRs contemplate that the Basel III requirements will become effective on January 1, 2013, subject to a phase-in period. The Standardized Approach is contemplated to become effective on January 1, 2015, with an option for early adoption.

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### BASEL III NPR

The NPR implementing Basel III, entitled *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III – Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action* (the “*Basel III NPR*”), with limited exceptions discussed below, would apply Basel III to all U.S. banks other than community banks with \$500 million or less in total consolidated assets. Banks commented extensively on the Basel III framework during its consideration by international regulators. These comments, however, were largely rejected by the BCBS and the Basel III NPR, and, for the most part, the Basel III NPR follows the final Basel III framework. Within the Basel III NPR, the Agencies have also addressed other aspects of U.S. bank capital regulation that interface with Basel III, most importantly the thresholds for remedial action under the Agencies’ prompt corrective action (“*PCA*”) regulations applicable to depository institutions (but not holding companies) and the phase-out periods for trust preferred securities and cumulative preferred stock as Tier 1 capital components for bank holding companies that are required by the Collins Amendment. Key features of the Basel III NPR include the following:

- **Capital Ratios.** The Basel III NPR follows Basel III in introducing the concept of CET1 and requiring banks to maintain, when fully phased-in, a minimum ratio of CET1 to risk-weighted assets of 4.5%, a

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minimum ratio of Tier 1 capital to risk-weighted assets of 6.0% (compared to the current 4.0% requirement), and a minimum ratio of total capital to risk-weighted assets of 8.0% (unchanged from current standards). The Basel III NPR proposes phase-in periods for the minimum capital ratios consistent with Basel III.

- **Components of Capital.** The Basel III NPR follows Basel III's definitions of the three components of capital – CET1, Additional Tier 1 Capital (which, together with CET1, is "*Tier 1 Capital*") and Total Capital – in all material respects. The Agencies note that they are considering adding a requirement for Additional Tier 1 Capital that is not in Basel III; namely, that the instrument would require a bank to have the ability to cancel or substantially reduce dividend payments on those instruments when the bank is paying a \$.01 dividend to its common shareholders. During the financial crisis, many banks reduced dividends to \$.01 as opposed to eliminating dividends because of the concern that certain classes of investors could not hold non-dividend paying shares. As a consequence, those banks could not defer payment of dividends on trust preferred securities or preferred stock. The Agencies have asked for comment on this proposal. The Basel III NPR does not address grandfathering of outstanding Additional Tier 1 Capital Instruments if this provision is implemented.
- **Phase-Out of Non-Qualifying Instruments.** Basel III requires the phase-out from Tier 1 Capital of trust preferred securities and cumulative preferred stock over a 10-year time period beginning on January 1, 2013; the Collins Amendment requires a phase-out of those instruments over a three-year period beginning on the same date, but only for bank holding companies that had \$15 billion or more in total consolidated assets as of December 31, 2009. The Basel III NPR:
  - for \$15 billion plus bank holding companies, phases these instruments out of Tier 1 Capital over a three-year period commencing January 1, 2013 (with 75% includible in Tier 1 Capital in 2013, 50% in 2014, 25% in 2015, and 0% thereafter); and
  - requires the phase-out of these instruments for bank holding companies having under \$15 billion in total consolidated assets as of December 31, 2009, albeit on Basel III's longer 10-year phase-out, permitting the inclusion of 90% of the carrying value of such instruments in 2013, with annual 10% decreases in the includible amount through 2021, until the instruments are fully phased-out on January 1, 2022.
- **Adjustments to Capital.** The Basel III NPR, like Basel III, provides that most adjustments to capital components are to CET1 as opposed to 50%/50% to Tier 1 and Tier 2 under the existing general risk-based capital requirements. Items to note include:
  - **AOCI.** The Basel NPR follows Basel III in removing the existing filter for unrealized gains and losses accumulated from available for sale securities recorded in accumulated other comprehensive income/loss ("*AOCI*") from regulatory capital measurements. Removal of the AOCI filter would be applied to CET1, with the impact of the filter's removal being phased-in 20% per year on an annual basis over five years commencing with 2014. The Agencies seek comment on an industry proposal that would exclude from the AOCI filter's removal unrealized gains and losses on debt securities whose valuations primarily change as a result of fluctuations in benchmark interest rates (for example, U.S. government and agency debt obligations, U.S. GSE debt obligations and other sovereign debt obligations that will qualify for a 0% risk weight under the Standardized Approach). The Agencies also seek comment on whether unrealized gains and losses on general obligations issued by states or political subdivisions of the United States should receive similar treatment even though such gains or losses are more likely to result from credit risk and not primarily from fluctuations in a benchmark rate.
  - **MSAs, DTAs and Investments in Non-consolidated Financial Entities.** The Basel III NPR follows Basel III in requiring that banks deduct from CET1 any of the following assets to the extent that individually the asset category exceeds 10% of CET1 or, in the aggregate, 15% of CET1: (i) deferred tax assets ("*DTAs*") arising from temporary differences that could not be realized through net operating loss carry-backs; (ii) mortgage servicing assets ("*MSAs*") net of associated deferred tax liabilities ("*DTLs*"); and (iii) significant investments in the capital of financial institutions in the form of common stock. In addition, significant investments in non-

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common stock capital instruments of such entities are to be deducted from the same tier of capital for which the instrument would qualify if issued by the bank itself.

- **Netting of DTLs.** The Basel III NPR, as compared to Basel III, permits expanded netting of DTLs against assets (other than DTAs) that are subject to deduction against CET1, provided that the DTLs are associated with the assets and the DTL will be extinguished if the associated asset becomes impaired or is de-recognized under GAAP.
- **Other.** The Basel III NPR includes a number of other adjustments, some of which are not in Basel III (for example, savings associations must deduct investments in bank-impermissible activities, banks must deduct indirect investments, including through indexes and total return swaps, in financial entities, and banks must deduct certain investments as required by Section 619 of Dodd-Frank and the implementing regulations thereunder (the “*Volcker Rule*”). The Basel III NPR proposes transition periods for the regulatory capital adjustments and deductions consistent with Basel III, and in certain cases requires institutions to apply specific risk weights to amounts not deducted or adjusted for certain capital items during the transition period.
- **Leverage.** The Agencies’ current rules require a minimum leverage ratio of 4% Tier 1 capital to average consolidated assets, subject to limited adjustments. The current rules also include a limited exception theoretically permitting banks with a supervisory composite rating of 1 to have a 3% Tier 1 leverage ratio. For the most part, banks outside the U.S. have not historically been subject to a leverage ratio. Basel III would impose a leverage ratio that is different from the existing U.S. standard and is measured as the ratio of Tier 1 capital to total leverage exposure, with (i) the minimum required ratio being 3%, and (ii) total leverage exposure defined much more expansively than under the existing U.S. rules to include a variety of off-balance sheet exposures. The Basel III NPR would:
  - maintain the Agencies’ existing 4% Tier 1 leverage requirement for all banks, but remove the existing permission for those with a supervisory composite rating of 1 to have a 3% ratio;
  - apply the Basel III leverage ratio, which inherently is more restrictive for many banks because of the more expansive definition of total leverage exposure as the denominator, to banks with \$250 billion or more in total assets or \$10 billion or more in total on-balance sheet foreign exposures (referred to in the NPRs as “*advanced approaches banks*”, as a supplementary measure (with advanced approaches banks being required to report the ratio commencing January 1, 2015, but the ratio not becoming a minimum requirement until 2018); and
  - for advanced approaches banks, include the Basel III leverage ratio among the standards in the PCA regulations.
- **Capital Conservation Buffer.** Basel III provides for a capital conservation buffer of 2.5%, composed of CET1 and added to each of the minimum requirements (that is, the minimum CET1, Tier 1 and Total Capital requirements). The Basel III NPR follows Basel III and would apply the capital conservation buffer to all banks. Banks that fall into their buffer are restricted in their ability to pay dividends and make other capital distributions and pay discretionary executive compensation. As a practical matter, banks will likely feel compelled to maintain capital at levels that include a meaningful cushion above the minimum requirements plus the 2.5% buffer in order to avoid the limitation on capital distributions and executive compensation that apply to those that fall into a buffer zone and in order to deal with the increased capital volatility resulting from the removal of the AOCI filter. The Basel III NPR phase-in periods for the capital conservation buffer are consistent with those in Basel III.
- **Countercyclical Capital Buffer.** Basel III includes a countercyclical buffer to be imposed by national regulators at their discretion to take into account the macro-financial environment and to protect banks from the systemic vulnerabilities that may build up during periods of excessive credit growth. The countercyclical capital buffer, if imposed, would augment the capital conservation buffer by up to an additional 2.5% (for a total buffer of 5.0%), with the consequences of falling into the expanded buffer zones being as described above in the context of the capital conservation buffer. The Basel III NPR provides for a potential countercyclical capital buffer following the Basel III approach but applies it only to advanced approaches banks.

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- **G-SIB Surcharge.** Basel III includes a CET1 capital surcharge of up to 3.5% for global systemically important banks. The Basel III NPR and the other NPRs do not address the G-SIB surcharge, although the Agencies note in the Basel III NPR that they plan to implement a surcharge for banks with \$50 billion or more in total consolidated assets, or a subset of those banks, based upon the BCBS's approach. This was foreshadowed in the FRB's notice of proposed rulemaking to implement enhanced prudential standards established under Section 165 of Dodd-Frank and the early remediation requirements established under Section 166 of Dodd-Frank.<sup>5</sup>
- **TARP Preferred.** The Basel III NPR confirms that preferred stock and other Additional Tier 1 Capital instruments issued under the Emergency Economic Stabilization Act of 2008 (so-called "*TARP Preferred*") will continue to qualify as Additional Tier 1 Capital notwithstanding that they include features not otherwise permitted for those instruments.
- **Loss Absorption.** Basel III requires that Additional Tier 1 Capital and Tier 2 Capital instruments be written off or converted into common equity if the issuer reaches a point of non-viability. The Basel III standards include an exception for banks in a jurisdiction whose laws require such instruments to be written off or otherwise fully absorb losses before tax payers are exposed to loss. The Agencies invoked that exception in the Basel III NPR and, accordingly, have not included Basel III's write-down or conversion requirement.
- **Prompt Corrective Action.** The existing PCA regulations include definitions of "*well capitalized*", "*adequately capitalized*", "*undercapitalized*", "*significantly undercapitalized*" and "*critically undercapitalized*". These regulations apply only to banks that are depository institutions (and not to bank holding companies). The PCA levels key off of ratios of total risk-based capital, Tier 1 risk-based capital and leverage capital. For example, in order to be well capitalized under current standards, a bank must have a total risk-based capital ratio of at least 10%, a Tier 1 risk-based capital ratio of at least 6% and a leverage ratio of at least 5%. The Basel III NPR would, among other things:
  - introduce a CET1 to risk-weighted assets requirement at each level (other than critically undercapitalized), with the required CET1 ratio being 6.5% for well-capitalized status;
  - increase the minimum Tier 1 capital to risk-weighted assets requirement for each category, with the minimum Tier 1 capital ratio for well-capitalized status being 8% (as compared to the current 6%);
  - for banks that are advanced approaches banks, introduce the supplementary Basel III-based leverage ratio as a component of the PCA matrix, with no supplementary leverage requirement for well-capitalized status but with a minimum supplementary leverage ratio of 3.0% for adequately capitalized status; and
  - eliminate the current provision that provides that a bank with a composite supervisory rating of 1 may have a 3% leverage ratio and still be well capitalized.
- **REIT Preferred.** The Basel III NPR confirms that exchangeable non-cumulative preferred instruments issued by real estate investment trust subsidiaries of banks would continue to qualify as Tier 1 capital instruments, but subject to Basel III's quantitative limits on the inclusion of minority interests and such entities' ability to declare so-called "consent dividends".

In the preamble to the Basel III NPR, the Agencies state that they have conducted an impact analysis to estimate the change in capital that banks would be required to hold to meet the proposed minimum capital requirements, and that "the vast majority of banking organizations currently would meet the fully phased-in minimum capital requirements as of March 31, 2012".

As indicated in the introduction to this memorandum, comments on the Basel III NPR (like the other NPRs) are due on September 7, 2012. Although the Basel III NPR does not specify an effective date or

implementation date, it contemplates that implementation will coincide with the Basel III implementation schedule, which commences on January 1, 2013.

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### STANDARDIZED APPROACH NPR

The NPR revising (or, perhaps more accurately, replacing) the general risk-based capital requirements with the Standardized Approach, entitled “*Regulatory Capital Rules – Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements*” (the “*Standardized Approach NPR*”), would apply to all banks (other than small bank holding companies with \$500 million or less in total assets), including state and federal savings associations and top-tier savings and loan holding companies. When the Agencies considered Basel II and in 2007 adopted portions of Basel II for U.S. banks, they adopted only the advanced internal ratings-based (“*A-IRB*”) approach to credit risk and the advanced approach for operational risks, and applied them only to the advanced approaches banks. Basel II also included a standardized approach (the “*Basel II standardized approach*”) that is considerably more risk-sensitive than the Basel I-based general risk-based capital requirements and is not dependent upon internal models but is heavily dependent upon credit ratings. In 2008 the Agencies proposed, as an option but not a requirement for U.S. banks that are not advanced approaches banks, an approach based upon the Basel II standardized approach.<sup>6</sup> The comment period for that proposal expired on October 27, 2008 in the midst of the financial crisis. The Agencies never proceeded with it.

The Standardized Approach NPR in part starts with, and expands upon, the initial endeavors from 2008 but with important differences, including (i) upon effectiveness, mandatory application to all subject banks (as opposed to optional application), and (ii) in view of the prohibition in Section 939A of Dodd-Frank on the use of credit ratings, replacement of the Basel II standardized approach’s heavy reliance on credit ratings with non-ratings-based alternatives. Key features of the Standardized Approach NPR include the following:

- **Risk-Weighting Categories.** As indicated in the introduction, the general risk-based capital requirements currently use four risk-weighting categories (0%, 20%, 50% and 100%). The Standardized Approach NPR would use a much larger number of categories, generally ranging from 0% for claims on the U.S. government and its agencies to 600% for certain equity exposures, and with risk weights in between (both as to the number of categories and the risk-weight for each category) depending upon the particular characteristics of the exposure being risk-weighted. Specifics include:
  - **U.S. Government, PSEs and Depository Institutions.** Risk-weightings assigned to the U.S. government, U.S. government-sponsored agencies, depository institutions and U.S. public sector entities (such as states and municipalities) are unchanged from the approach in the general risk-based capital requirements (for example, 0% for the U.S. government and its agencies and 20% for U.S. government-sponsored entities and depository institutions).
  - **Foreign Sovereigns, PSEs and Depository Institutions.** Exposures to foreign sovereigns and foreign banks are based on which of the seven CRC categories the relevant sovereign (including, in the case of a bank, the sovereign of the bank’s jurisdiction) is assigned to, with risk weights ranging from 0% for a sovereign in CRC category 0 or 1 to 150% for a sovereign in CRC category 7. A foreign sovereign exposure would be assigned a 150% risk weight if a

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sovereign default (defined as noncompliance by a sovereign with its external debt service obligations or the inability or unwillingness of a sovereign government to service an existing loan according to its original terms) has occurred within the preceding five years.

- **Corporates.** Corporates that are not depository institutions or securitization vehicles are generally assigned a 100% risk-weighting.
- **Residential Mortgages.** For residential mortgage exposures, the current approach of a 50% risk weight for high-quality seasoned mortgages and a 100% risk-weight for all other mortgages is replaced with a matrix resulting in a risk weight of 35%, 50%, 75%, 100%, 150% or 200% depending upon the mortgage's loan-to-value ratio and whether the mortgage is a category 1 residential mortgage exposure (defined by reference to eight criteria that include a 30-year maximum term and preclude negative amortization, balloon payments and increases in the annual rate of interest of more than 2 percentage points in any 12-month period and 6 percentage points over the life of the exposure) versus category 2 residential mortgage exposures (which are all other mortgages).
- **Commercial Real Estate.** Assign a 150% risk-weighting to certain commercial real estate exposures that currently receive a 100% risk weight but that are high volatility commercial real estate exposures.
- **Off-Balance Sheet Items.** The Standardized Approach NPR would make important changes to the treatment of off-balance sheet exposures as compared to the current treatment, including:
  - application of a 20% credit conversion factor (that is, the factor used to convert an off-balance sheet exposure to an asset equivalent, or "CCF") for commitments with an original maturity of one year or less that are not unconditionally cancellable, compared to the existing 0% CCF; and
  - application of a 100% CCF to off-balance sheet guarantees, repurchase agreements, securities lending or borrowing transactions and financial standby letters of credit and forward agreements, compared to existing standards that either risk weight only related on-balance sheet assets or do not require certain exposures to be risk weighted.
- **OTC Derivative Contracts.** Under the Standardized Approach NPR, the method for risk-weighting both single and netted OTC derivative contracts would remain similar to the general risk-based capital requirements, and would apply a potential future exposure conversion matrix to OTC derivative contracts, based upon the nature of the contract and its remaining maturity, that could result in a risk weight exceeding the current cap of 50%.
- **Cleared Transactions.** The Standardized Approach NPR would generally apply advantageous risk-weighting to derivatives and repurchase-style transactions that are cleared through a central counterparty.
- **Credit Risk Mitigation.** The general risk-based capital requirements permit only very limited recognition of guarantees and collateral as credit risk mitigants. The Standardized Approach NPR would substantially expand the scope of (i) eligible guarantors (to include, for example, investment grade corporate entities, subject to certain limitations), and (ii) eligible collateral (to include, for example, corporate debt securities that are investment grade, equity securities that are publicly traded and convertible bonds that are publicly traded). The Standardized Approach NPR appears to adopt a "substitution approach" as to eligible credit protection providers (including under eligible guarantees and eligible credit derivatives) that requires a bank to calculate capital assuming a shift of the exposure to the protection provider, similar to the single counterparty credit limit exposure calculations under the rules proposed by the FRB implementing Section 165(e) of Dodd-Frank. The expanded use of collateral is accompanied by required haircuts that are either "standard supervisory haircuts" based upon a matrix in the proposed rules or, if the bank meets certain tests, the bank's own estimate.
- **Securitizations.** With respect to the securitization positions, the Standardized Approach NPR would generally require banks to calculate risk-weights using either (i) the same SSFA formula adopted as part of the Market Risk Amendments (discussed below), or (ii) for banks not subject to the Market

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Risk Amendments, a gross-up approach based on the subordination of the securitization exposure as provided under the current Basel I-based capital rules. The chosen method would have to be used uniformly for all securitization exposures. Alternatively, banks could choose to apply a 1,250% risk weight to any securitization exposure.

- **Insurance Companies.** The Standardized Approach NPR includes several provisions of specific relevance to insurance companies, including:
  - permitting assignment of a 0% risk weight to assets held in non-guaranteed separate accounts where all the losses are passed on to the contract holders;
  - an affirmative statement that surplus notes do not qualify as Tier 1 Capital; and
  - a requirement that bank holding companies and savings and loan holding companies that own regulated insurance subsidiaries deduct the minimum regulatory capital requirement of the insurance subsidiaries (generally 200% of each subsidiary's authorized control level as established by the appropriate state insurance regulator) from the holding company's total capital in order to reflect the capital needed to cover insurance risks.
- **Collins Amendment Floor.** The Standardized Approach, when effective, would replace the general risk-based capital requirements as the floor mandated by the Collins Amendment for the advanced approaches banks that also calculate capital using the A-IRB.
- **Disclosure and Market Risks.** At present, only advanced approaches banks that are currently subject to the Agencies' Basel II-based standards are subject to specific disclosure requirements (as part of "Pillar III" of those standards). The Standardized Approach NPR would impose quarterly disclosure requirements on the top-tier holding company in a banking group of \$50 billion or more in total consolidated assets. The content and formatting of the required disclosure are set forth in 10 tables in the Standardized Approach NPR and address, among other things, corporate structure, capital structure, where the organization stands with respect to its capital conservation buffer, and disclosures with respect to securitization activities, investments in equity securities and interest rate risks for non-trading activities.

Comments on the Standardized Approach NPR, like the other NPRs, are due on September 7, 2012. The changes in the Standardized Approach NPR are proposed to take effect on January 1, 2015, with an option for early adoption.

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## MARKET RISK AMENDMENTS

The Market Risk Amendments implement revisions to the Agencies' market risk rules proposed in two notices of proposed rulemaking, the first released in January 2011 (the "January NPR") and the second issued in December 2011 (the "December NPR"). The January NPR proposed to implement revisions to capital standards for market risk generally consistent with the market risk capital framework adopted by the BCBS between April 2004 and June 2010, other than revisions that would have required the use of credit ratings. The December NPR proposed alternative standards of creditworthiness consistent with the requirements of Section 939A of Dodd-Frank. Section 939A requires the Agencies to remove all references to and requirements of reliance on credit ratings from their regulations and replace them with alternative standards of creditworthiness.



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Subject to certain important changes described below, the Market Risk Amendments implement the proposed revisions in the January NPR and December NPR in large part as proposed. Key features of the Market Risk Amendments include the following:

- **CRM Surcharge.** Under the January NPR, a bank approved to measure comprehensive risk for correlation trading positions would be required to calculate a comprehensive risk measure (“CRM”) that equals the sum of the output from the bank’s approved comprehensive risk model and a 15% surcharge on the bank’s modeled correlation trading positions calculated in accordance with the standardized measurement method for specific risk. Over time, with approval from its primary federal regulator, a bank would be permitted under the January NPR to use a floor approach to calculate its CRM. This surcharge was criticized for being risk insensitive, excessive and inconsistent with Basel II.5, which does not contain such a surcharge. In order to balance these concerns and the Agencies’ concerns about deficiencies in CRM models, the Agencies retained the surcharge but reduced its size from 15% to 8%.
- **Redundancy in Capital Calculations.** The January NPR was criticized for the redundancy of certain of its components. For example, the stressed VaR-based measure is definitionally duplicative of the VaR-based measure, with the calculations capturing the same risks, but with stressed VaR using model inputs from a period of significant financial stress. The Agencies did not make changes to address this issue as they believe that, although duplicative in such respects, the market risk amendments provide a “prudent level of conservatism in the market risk capital rule”.
- **Due Diligence Requirements for Securitizations.** The January NPR imposed substantially heightened diligence requirements on securitizations positions. Commenters had expressed concern regarding the practicability of these requirements as applied to trading activities given the need to satisfy them before acquisition of the relevant position and the speed with which many trades need to be executed. To address these issues, the Agencies revised the Market Risk Amendments to allow banks up to three business days after the acquisition of a securitization position to document its due diligence. The Market Risk Amendments also provide that positions acquired before the final rule becomes effective will not be subject to the documentation requirement.
- **Decomposition and Look Through.** In order to better reflect the actual risk of a securitization and its hedges, commenters had suggested the inclusion of the ability to decompose the components of tranching securitization products in an index in order to give effect to the netting of long and short positions and hedges. The Agencies responded that netting is allowed under the Market Risk Amendments, consistent with the January NPR, for long and short securitization positions in identical issues or indices but not across positions in different issues or indices, and thus this netting treatment would not be available. Commenters had also requested the ability to use a look-through approach for untranching indices that would allow netting at the individual issuer level of index positions against individual issuer credit derivative exposures. In contrast to the decomposition issue, the Market Risk Amendments allow this approach because netting of exposures between the individual issuer level and the index is possible and changes in the market value of certain components of an index can be matched with individual issuer exposures.
- **The CRC Methodology.** The December NPR proposed to require banks to generally determine the standardized specific risk capital requirement for sovereign debt positions based on CRCs. Banks criticized the CRC methodology for lacking risk sensitivity and transparency. The Agencies acknowledged that the CRC has limitations but, nevertheless, adopted the CRC-based methodology largely as proposed in the Market Risk Amendments (as well as in the Standardized Approach NPR discussed above). The Agencies noted that further study is needed to determine whether market-based methodologies would be feasible and appropriate alternatives to the CRC-based methodology.
- **Treatment of Fannie Mae/Freddie Mac Debt Exposures.** Commenters suggested that the Agencies treat debt exposures to Fannie Mae and Freddie Mac as being effectively backed by the United States government and assign them the same specific risk-weighting factor as sovereign debt positions backed by the full faith and credit of the United States (which is zero). The Agencies declined to extend this treatment to these exposures, because Fannie Mae and Freddie Mac are not explicitly backed by the full faith and credit of the United States.

- **Corporate Debt Positions.** The December NPR has proposed a methodology using several financial and market indicators for assigning standardized specific risk capital requirements to debt positions that are exposures to a publicly traded non-financial corporation. The Agencies declined to implement this approach in light of its apparent deficiencies, including counter-cyclicality and risk insensitivity. In its place, the Agencies adopted the “*investment grade*” approach that is based on an approach that the OCC implemented in its investment securities regulations – namely, treating an exposure as investment grade if the obligor “has adequate capacity to meet financial commitments for the projected life of the asset or exposure”, with the “adequate capacity” test being met if “the risk of [the obligor’s] default is low and the full and timely repayment of principal and interest is expected”. Based on the bank’s determination of whether a corporate debt position eligible for treatment under the investment grade methodology is investment grade, the bank must assign a specific risk-weighting factor based on the category and remaining contractual maturity of the position (with specific risk weights ranging between 6.25% and 150%). Additionally, the Agencies decided not to implement the December NPR’s proposed “simple methodology”, which would have given banks subject to the market risk rules the option to assign a specific risk-weighting factor of 100% to all corporate debt positions.
- **The Simplified Supervisory Formula Approach (“SSFA”).** The December NPR proposed that the specific risk-weighting factors of securitization positions be determined using the SSFA. The SSFA is a formulaic approach that would determine specific risk-weighting factors for a position based on several inputs, including  $K_G$ , a weighted average capital requirement of the underlying exposures using the Agencies’ general risk-based capital rules; the attachment and detachment point of the position; a supervisory calibration parameter; and a floor that would have increased from 20% to as high as 1250% when cumulative losses on the underlying assets of the securitization exceeded 150% of  $K_G$ .  
To improve the risk sensitivity of the SSFA and make it more forward-looking, the Agencies included in the Market Risk Amendments a modification to the SSFA, replacing the floor with an adjustment of  $K_G$ , called  $K_A$ , which is based in part on the weighted average of the  $K_G$  value and the multiple of a fixed parameter equal to 0.5 and the weighting variable  $W$ , where  $W$  is ratio of the sum of the dollar amounts of any underlying exposures within the securitized pool that are “delinquent” to the ending balance, measured in dollars, of underlying exposures. Delinquent exposures for these purposes are those that are 90 days or more past due, subject to a bankruptcy or insolvency proceeding, in the process of foreclosure, held as real estate owned, have contractually deferred interest payments for 90 days or more or are in default.
- **Relationship to the Volcker Rule.** The Agencies clarified that the definition of “trading account” for purposes the Volcker Rules’ proprietary trading prohibitions and the definition of “trading position” for purposes of the applicability of the Market Risk Amendments are essentially the same. Therefore, the Volcker Rule’s proprietary trading prohibition, according to the Agencies, would cover all positions covered by the Market Risk Amendments, subject to the Volcker Rule’s exceptions, thereby eliminating any potential for inconsistency or regulatory arbitrage in which a bank might characterize a position as “trading” for purpose of the market risk rules but not for purposes of the Volcker Rule NPR.

The Market Risk Amendments will apply to any bank that has trading assets and liabilities of at least \$1.0 billion or 10% of its total assets and will become effective January 1, 2013, although the Agencies note that they are “committed to continued improvement of the market risk framework”.

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### ADVANCED APPROACHES NPR

Although Basel III mostly address the components of capital and the minimum ratios, certain aspects of Basel III address risk weights and other aspects of the denominator in risk-based capital ratios, generally in the context of the advanced approaches and market risk standards for advanced approaches banks.

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The third NPR, entitled *Regulatory Capital Rule: Advanced Approaches Risk-Based Capital Rules; Market Risk Capital Rule* (the “Advanced Approaches NPR”), addresses proposed amendments to the Agencies’ Basel II-based capital guidelines, referred to in the Advanced Approaches NPR as the “advanced approaches risk-based capital rule”. Key features of the Advanced Approaches NPR include the following:

- **Counterparty Credit Risk.** The recent financial crisis highlighted certain aspects of the treatment of counterparty credit risk under the Basel II framework that were broadly viewed as inadequate. Basel III includes provisions addressing this issue, some of which are ratings-based. The Advanced Approaches NPR generally follows the Basel III approach, modified to incorporate alternative standards to credit ratings. Among other provisions:
  - **Re-securitizations.** The advanced approaches capital rule recognizes a broad scope of financial collateral that qualifies as eligible financial collateral for purposes of calculating exposure-at-default, or “EAD”. The Advanced Approaches NPR would exclude re-securitizations from eligible financial collateral for this purpose.
  - **Revised Supervisory Haircuts.** Basel III addresses the increased volatility of securitization exposures relative to other collateral types by imposing new standardized supervisory haircuts for securitization exposures in calculating EAD. Basel III does so using a rating-based approach. Because of the prohibition in Section 939A of Dodd-Frank on the use of ratings, the Advanced Approaches NPR addresses this issue with non-ratings-based approaches that mirror those used in the Standardized Approach and the Market Risk Amendments (including CRCs for sovereigns).
  - **Holding Periods and Margin Period of Risk.** The existing advanced approaches risk-based capital rule, like Basel II, uses a minimum assumed holding period for collateral and margin period of risk of five days for repo-style transactions and 10 days for other collateralized transactions where liquid collateral was posted under a daily maintenance requirement. Generally speaking, Basel III uses a minimum holding period of 20 business days. The Advanced Approaches NPR adopts the Basel III approach.
  - **Stressed Inputs for IMM.** Consistent with Basel III, the Advanced Approaches NPR requires that capital requirements for internal models methodology (“IMM”) exposures must be equal to the larger of the capital requirement for those exposures calculated using data from the most recent three-year period and data from a three-year period that contain a period of stress reflected in the credit default spreads of the bank’s counterparties. An “IMM” exposure would be defined as a repo-style transaction, eligible margin loan, or OTC derivative for which a bank calculates its EAD using the IMM.
  - **Credit Valuation Adjustments (“CVA”).** CVA is the fair value adjustment to reflect counterparty credit risk in the valuation of an OTC derivative contract. The Agencies, along with international regulators, concluded that a substantial portion of counterparty credit risk losses during the crisis were due to mark-to-market losses from CVA as compared to actual defaults. In order to address market risk associated with CVA, the Advanced Approaches NPR would require a bank to multiply its CVA capital requirement as otherwise calculated by 12.5. Because the multiplier would account for market risk, the 1.06 multiplier applied to credit risk-weighted assets under the existing advanced approaches risk-based capital rule would not apply to the CVA risk-weighted asset.
- **Removal of Credit Ratings.** The existing advanced approaches risk-based capital rule uses credit ratings in a number of contexts, including for purposes of establishing whether a guarantee is an eligible risk mitigant. The Advanced Approaches NPR generally replaces uses of credit ratings with the alternatives, depending upon the nature of the exposure, described above in the context of Standardized Approach and the Market Risk Amendments.

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- **Securitization Exposures.** The Advanced Approaches NPR substantially revises the existing advanced approaches risk-based capital rule's approach to securitizations, including removal of ratings in a manner generally consistent with the Standardized Approach NPR.

As indicated in the introduction to this memorandum, comments on the Advanced Approaches NPR (like the other NPRs) are due on September 7, 2012. The Advanced Approaches NPR does not contemplate a specific implementation date.

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ENDNOTES

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- <sup>1</sup> Except where otherwise indicated, we are using the term “*bank*” to include U.S. bank holding companies, savings and loan holding companies and depository institutions (both banks and thrifts).
- <sup>2</sup> The market risk capital framework, as revised through the following publications, is commonly referred to as “*Basel II.5*”: BCBS and International Organization of Securities Commissions, *The Application of Basel II to Trading Activities and the Treatment of Double Default Effects* (April 2005), available at <http://www.bis.org/publ/bcbs111.pdf>; BCBS, *Enhancements to the Basel II Framework* (July 2009), available at <http://www.bis.org/publ/bcbs157.pdf>; BCBS, *Revisions to the Basel II Market Risk Framework*, (July 2009), available at <http://www.bis.org/publ/bcbs158.pdf>; BCBS, *Guidelines for Computing Capital for Incremental Risk in the Trading Book* (July 2009), available at <http://www.bis.org/publ/bcbs159.pdf>; and BCBS, *Changes to the Revisions to the Basel II Market Risk Framework* (June 2010), available at <http://www.bis.org/press/p100618/annex.pdf>.
- <sup>3</sup> “*Basel III*”, as used in this memorandum, refers to the BCBS’s publications titled *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* and *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring*.
- <sup>4</sup> “*Basel II*”, as used in this memorandum, refers to the BCBS’s comprehensive accord titled *International Convergence of Capital Measurement and Capital Standards – A Revised Framework*.
- <sup>5</sup> *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies*, 77 Fed. Reg. 594 (Jan. 5, 2012).
- <sup>6</sup> *Risk-Based Capital Guidelines; Capitalized Adequacy Guideline: Standardized Framework*, 73 Fed. Reg. 43983 (July 29, 2008).

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