A Closer Look

US Basel III Regulatory Capital Regime and Market Risk Final Rule

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The Federal Banking Agencies Propose New Basel III Regulatory Capital Regime for US Banking Organizations

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Our perspective

In a long-anticipated but not eagerly-awaited action, the three federal banking agencies ("the Agencies") released three notices of proposed rulemaking (NPRs) that will revise regulatory capital rules for US banking organizations and align them with the Basel III capital standards that were issued in December 2010 and subsequently updated in 2011[1] (Basel III). The NPRs establish tougher capital standards through more restrictive capital definitions, higher risk-weighted assets (RWA), additional capital buffers, and higher requirements for minimum capital ratios. Once incorporated into the US regulatory capital framework, the Basel III reforms will fundamentally impact profitability and transform the business models of many banks. These proposed reforms will also require these organizations to undertake significant process, data management, and system changes to achieve upgrades in the areas of data management, stress testing, counterparty risk, and capital management infrastructure.

[1] Basel Committee on Banking Supervision. "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems". December 2010 (revised June 2011).

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The release of this US implementation regime for Basel III is a milestone in the G 20 Agenda on financial regulatory reform. However, as Federal Reserve Governor Daniel Tarullo recently pointed out in testimony, an important capital initiative that has yet to be completed pertains to additional capital requirements for systemically important financial institutions (SIFIs), on which the Governor indicated consensus was still being sought.

The NPRs are also designed to comply with aspects of the Dodd-Frank Act (DFA), in particular, the Collins Amendment which establishes minimum risk-based capital and leverage requirements on a consolidated basis for insured depository institutions, their holding companies and nonbank SIFIs. The NPRs also reflect the influence of Section 939A of the DFA that requires the removal of all references to external credit ratings from federal regulations and their replacement with new standards of creditworthiness.

While the proposals, which total more than 700 pages, deal with a large number of issues, the following merit special attention:

- The proposed rules will apply to all US banks and savings associations (national and state-chartered), federal savings associations and US domiciled Bank Holding Companies (BHCs) with assets of $500 million and greater. In addition, all Savings and Loan Holding Companies (SLHCs), irrespective of size, will have to comply with federal capital standards for the first time. (All the aforementioned institutions shall collectively be referred to as “banking organizations.”)
- The proposed rules will establish minimum risk-based and leverage standards that will create the Collins Amendment “floor.”
- The quantitative liquidity framework and Global Systemically Important Bank (G-SIB) surcharge are not part of the NPRs and will be included in subsequent proposals.
- Banking organizations subject to the “Standardized Approach” will face more risk-sensitive capital rules with risk weights by specific obligor type, delinquency status, and, in some cases, underwriting attributes.
- “Advanced Approaches banking organizations” (those with consolidated assets greater than$250 billion or consolidated on-balance sheet foreign exposures of at least $10 billion) will have to meet the following enhanced requirements:
    - Comply with the “US Leverage Ratio” and Supplementary Basel III Leverage ratio by January 1, 2018
    - Calculate risk-based capital requirements under both the Standardized Approach and Advanced Approach to comply with the Collins Amendment
    - Prepare for the possibility of countercyclical buffer requirements
- Revised minimum ratios under the Prompt Corrective Action (PCA) Framework will be established.
- The key differences between the Agencies’ NPRs and Basel III include:
    - Different provisions for the phasing-out of certain capital instruments to comply with the Collins Amendment
    - Requirement to deduct Deferred Tax Assets (DTAs) and goodwill, net of Deferred Tax Liabilities (DTLs), in the calculation of Common Equity Tier 1 capital beginning in 2013, a more accelerated schedule than that required under Basel III

  - US banking organizations will not be required to deduct defined benefit pension fund assets if the organization has unconstrained and unrestricted access to the assets
  - Deductions from Tier 1 capital for investments made in hedge funds and private equity funds in compliance with the Volcker Rule covered funds provisions
- Major changes from the current methodology of calculating RWA that will impact banking organizations and capital markets.
  - Standardized Approach: residential mortgages; acquisition, development and construction loans; equity exposures; off-balance sheet exposures; cleared derivatives; repo-style transactions; unsettled transactions; and securitization exposures
  - Advanced Approach: cleared derivatives; repo-style transactions; securitization exposures; and counterparty credit risk
- Federal Reserve Governor Tarullo has also noted in testimony that the potential for international differences in the calculation of RWA has been gaining attention. Analysts have pointed out that large US banking organizations generally have markedly higher average RWA, ratios of RWA to total assets and ratios of common equity to total assets (adjusted for accounting differences) when compared to some of their foreign competitors.

Overview of the proposed risk-based capital rules and market risk final rule

In an effort to enable each banking organization to focus on those aspects most applicable and important to its capital management, the Agencies have divided the proposals into three separate NPRs. The comment period on each of the three NPRs ends on September 7, 2012.

The first NPR (the Basel III NPR) will apply to all US depository institutions, US domiciled BHCs with consolidated assets in excess of $500 million, and all SLHCs. The NPR will implement aspects of Basel III that redefine the components of regulatory capital (the numerator in the regulatory capital ratios), minimum regulatory capital ratios, and new regulatory capital buffers above the minimums. The PCA framework will also be changed to reflect the new measures.

The second NPR (the Standardized Approach NPR) revises the rules for calculating RWA (the denominator in the regulatory capital ratios) to enhance risk sensitivity and address other perceived weaknesses in the current framework that were exposed during the financial crisis. The second NPR will also include aspects of the Basel II Standardized Approach.

The third NPR (the Advanced Approaches and Market Risk NPR) will apply only to banking organizations subject to the Advanced Approaches risk-based capital rules, the Market Risk Final Rule, or both. The Advanced Approaches NPR will be applied to banking organizations that have consolidated assets of at least $250 billion or consolidated on-balance sheet foreign exposures of at least $10 billion. US banking organizations with aggregate trading assets and trading liabilities equal to at least 10% of total assets or $1 billion are also subject to the Market Risk Final Rule. The third NPR will integrate the Market Risk Final Rule into the new framework and incorporate changes to the Basel Advanced Approaches to better reflect the risk from counterparty credit exposures and

interconnectedness among financial institutions in the RWA (the denominator in the regulatory capital ratios) of banking organizations. SLHCs will also become subject to the Advanced Approaches rules and market risk capital rule if they meet the relevant thresholds.

Transition arrangements. To ensure US banking organizations have sufficient time to adjust to the Basel III NPRs, a transitional framework has been proposed that will phase in compliance with the new rules between January 1, 2013 and January 1, 2019. The Standardized Approach NPR has an effective date of January 1, 2015; however, US banking organizations may elect to be early adopters of the proposed rules once finalized. The Agencies' General risk-based capital rules, as amended by the Standardized Approach NPR and along with the Basel III NPR, will serve as the floor for risk-based capital requirements under the Collins Amendment to DFA.

Market risk final rule

The Agencies also approved a final rule that will revise the existing market risk rules to incorporate certain changes made by the Basel Committee on Banking Supervision (BCBS) to its international standards for market risk between 2005 and 2010, commonly known as Basel 2.5. The revised rule will continue to apply to any US banking organization that has trading assets and liabilities of at least $1 billion or 10% of total assets. The revisions include the consideration of stressed conditions when modeling market risk capital requirements, reduction of opportunities for regulatory arbitrage between market risk and credit risk-based models, changes to the modeling standards for specific risk, removal of references to external credit ratings, and enhanced disclosure requirements. The Market Risk Final Rule has an effective date of January 1, 2013.

Minimum capital requirements, capital buffers and definitions of capital

With a few exceptions, the Basel III NPR generally mirrors Basel III. The proposed Basel III framework includes higher minimum capital requirements, more restrictive definitions of regulatory capital instruments, and new capital buffer requirements. These amendments also implement elements of DFA. The transition periods for many of these proposals are consistent with Basel III and DFA. Key highlights of minimum capital requirements and definitions of capital include:

- While new minimum capital requirements are 4.5%, 6.0% and 8% for Common Equity Tier 1 Capital (CET1), Tier 1 Capital (Tier 1) and Total Capital respectively, the requirement for an additional 2.5% of CET1 for the capital conservation buffer generally pushes minimum requirements to 7% for CET1, 8.5% for Tier 1 and 10.5% for Total Capital for those firms that do not wish to be subject to restrictions on capital actions and compensation for executives.
- The PCA ratios for "well capitalized" organizations imply a cushion of 2% over the minimum capital ratios, which is slightly lower than the 2.5% conservation buffer outlined in the Basel III NPR.
- Guidelines for a countercyclical capital buffer of up to 2.5% for Advanced Approaches organizations to be imposed at the discretion of the Agencies under periods of excessive credit growth or asset price acceleration.
- The NPR proposes more stringent capital deductions, with the bulk of those deductions affecting CET1.

- The inclusion of unrealized gains and losses on all Available for Sale (AFS) portfolios in CET1 will lead to more volatile capital levels.
- US regulators opted to narrow the application of the Basel III supplementary leverage ratio to only those firms that are required to adopt the Advanced Approach.
- The existing US leverage ratio will continue to be applicable to all US banking organizations. However, the calculation method will now reflect the revised definitions of capital.

Minimum capital requirements

The Basel III NPR proposes a minimum CET1 requirement of 4.5%, a supplementary minimum leverage requirement for Advanced Approaches firms of 3%, and the addition of capital conservation and countercyclical buffers. The proposal also requires an increase in the minimum Tier 1 capital requirement from 4% to 6%, but leaves the Total Capital requirement unchanged at 8%. While the minimum US leverage ratio was left unchanged at 4%, the NPR eliminates an exemption that allowed certain firms to reduce the minimum requirement to 3%. Phase-in arrangements are summarized in Appendix A.

Minimum Common Equity Tier 1, Tier 1 Capital and Tier 2 capital requirements

The CET1 requirement will ensure that the predominant component of Tier 1 capital is of the highest quality and is generally consistent with the definitions that are included in Basel III. CET1 includes common equity (subject to specific criteria regarding subordination and dividends), retained earnings, and common stock of minority interests (subject to limitations). The more significant change is the incorporation of unrealized gains and losses in the Tier 1 capital calculation. Under this proposal, all gains and losses stemming from non-credit events would flow through to CET1.

Consistent with Basel III, additional Tier 1 capital will consist of equity capital instruments that meet specified eligibility criteria and some minority interests; however, one eligibility element is slightly different in the US proposal. Specifically, an "other Tier 1 instrument" must not limit a firm's ability to cancel dividend payments or other capital distributions without triggering a default or other restrictions on the firm with the exception of distributions pertaining to common stockholders.

Revisions to Tier 2 capital include the elimination of existing limits on qualifying Tier 2 capital and certain instruments (term subordinated debt, trust preferred securities, and limited-life preferred stock). Furthermore, Tier 2 capital for Standardized Approach firms will include the amount of the Allowance for Loans and Lease Losses (ALLL) that does not exceed 1.25% of its total standardized RWA less the ALLL. Alternatively, for Advanced Approaches firms, inclusion of excess ALLL would be limited to 0.6% of total credit RWA.

Beyond the minimum requirements above, there are no requirements for additional Tier 1 or Tier 2 capital, as well as no ceilings on Tier 2 capital.

Minimum Tier 1 leverage and supplementary leverage requirements

The NPR maintains the existing Tier 1 Leverage Ratio minimum requirement and establishes a new Supplementary Leverage Ratio applicable to Advanced Approaches firms. This broadens the definition of the denominator of the ratio to include potential exposure from derivative contracts and other off-balance sheet exposures.

Minimum Tier 1 leverage ratio. The minimum Tier 1 Leverage Ratio that is applicable to all US banking organizations has been left unchanged at 4%. However, the calculation methodology has been amended to include the changes to Tier 1 capital. Additionally, the exemption permitting a 3% Tier 1 leverage ratio has been eliminated. This capital requirement is particular to US banking organizations.

Supplementary leverage ratio. In addition to the Tier 1 leverage minimum requirement, Advanced Approaches firms will need to meet a minimum Supplementary Leverage ratio of 4%. The numerator of the ratio is calculated using the same approach used for the Tier 1 leverage ratio. However, the denominator is more expansive (including a measure of potential future exposure for derivatives contracts), with 10% of the notional value and the notional amount of all other off-balance sheet exposures (excluding securities lending transactions and items already captured). As noted, treatment of repo-style transactions remains unchanged. However, the NPR notes that further discussions regarding the appropriateness of alternative measurement approaches of these exposures are ongoing.

Capital buffers

Consistent with Basel III, all firms will be subject to a capital conservation buffer of up to 2.5% of CET1. However the countercyclical buffer will only be applicable to firms that are subject to the Advanced Approach.

Capital conservation buffer. The capital conservation buffer will be composed of CET1. While the buffer is separate from minimum capital requirements, it carries significant implications on capital distributions and executive compensation should the buffer fall below 2.5% of RWA. The sufficiency of buffer capital is determined by the lowest excess of CET1, Tier 1 and Total Capital as compared with the relevant minimum capital requirement calculated under the appropriate approach.

Countercyclical buffers. The countercyclical buffer, which is in addition to the capital conservation buffer, will initially be set at zero. However, it could be set as high as 2.5% of a firm's RWA depending on the Agencies' concerns about excessive credit growth and/or asset price acceleration in the US and in foreign jurisdictions. The buffer will be applied generically to entities subject to the Advanced Approach. A methodology regarding how the buffer will be calculated or calibrated was not part of the NPR. However, the buffer will only be applicable to private sector exposures. The proposal does provide for a period of up to 12 months for firms to fund the buffer once it is announced and an automatic expiration of the required buffer 12 months after the effective date (unless regulators opt to extend the buffer requirement).

Other revisions to the definition of capital

As noted, the NPR includes significant revisions to the range of capital deductions coupled with a realignment of deductions away from Tier 1 capital to CET1 capital. The more impactful changes include:

- Goodwill and carry-forward DTAs will be deducted from CET1 capital.
- Mortgage servicing rights (MSRs), DTAs and investments in common stock of unconsolidated financial intuitions will be individually limited to 10% of CET1 and in aggregate to 15% of CET1.
- Unrealized gains and losses on certain cash flow hedges will flow through to CET1.

Prompt corrective action

The NPR proposes slightly differing PCA standards for Advanced Approaches banking organizations mainly due to the inclusion of the supplementary leverage ratio requirement. Other changes include augmenting risk-based thresholds with the CET1 ratio, the addition of a critically undercapitalized measure that triggers a 90-day timeline for a firm to be put into receivership, and revisions to minimum capital level thresholds for Tier 1 and leverage ratios (see Appendix B).

Standardized approach for risk weighted assets

Under the Standardized Approach NPR, all US banking organizations will be held to the same minimum requirements for the calculation of RWA beginning January 1, 2015. While the approach and methodologies outlined in the NPR are similar to the current general risk-based capital rules, specific changes have been proposed to better align regulatory requirements with the Basel II Standardized Approach and expectations outlined in DFA, including the removal of references to external credit ratings. As with the other NPRs, the overall intent of these changes is to increase the risk sensitivity of capital requirements associated with a banking organization's various on- and off-balance sheet exposures.

To achieve the level of risk sensitivity proposed in this NPR, banking organizations will be required to categorize and break down exposures by specific obligor type, delinquency status, and in some cases underwriting attributes. For some organizations, limited visibility into some of these attributes may require manual intervention to properly identify and segregate the portfolios. For more sophisticated organizations, current data management and reporting processes may, at a minimum, need to be updated to accommodate new definitions and rules.

General credit risk

To provide some sense as to the level of change and new requirements proposed in this NPR, RWA assignments for credit exposures have been summarized by exposure type in **Table 1** below.

Table 1. Summary of risk weights for general credit risk

Counterparty/exposure type	Risk weight	Change from general rule
US government, US central bank and US government agencies (includes exposures unconditionally guaranteed by any of the above) Portion of deposits insured by the FDIC or National Credit Union Administration	0%	No material changes.
Specified supranational entities and multilateral development banks	0%	Risk weighting for certain named entities are reduced from 20%.
Foreign sovereigns Foreign banks Foreign public sector entities	0% to 150%	Elimination of credit ratings with risk weights based on OECD country ratings. The maximum weight is assigned in situations of sovereign default.

Counterparty/exposure type	Risk weight	Change from general rule
Government sponsored entities	20% – Debt 100% – Equity	Increases the risk weight for preferred stock for OCC regulated entities from 20%.
Depository institutions, foreign banks and credit unions	20% to 150%	Replaces the flat 20% rate for US depository institutions and OECD foreign banks, and the 20%/100% rates for non-OECD foreign banks with a sliding scale aligned with OECD country ratings. The maximum weight is assigned in situations of sovereign default.
Securities firms	100%	Certain exposures will be treated as corporate exposures instead of exposures to depository institutions.
Trade finance contingent liabilities	20%	Removes the sovereign floor for self liquidating trade finance exposures.
US and foreign public sector entities	20% to 150%	Replaces flat risk weights ranging from 20% to 100% with a sliding scale based on OEDC country ratings and a segregation based on general versus revenue-based obligations.
Corporate exposures	100%	The definition of corporate exposures has been expanded and now includes securities firms.
Residential mortgages guaranteed by the US Government or its agencies	0% or 20%	No material changes noted.
Residential mortgages	35% to 200%	Replaces flat risk weights of 50% and 100% by employing a low/high risk categorization and a sliding scale based on LTVs. The maximum weight is assigned to delinquencies over 90 days past due. Treatment of restructured transactions has also been revised.
Pre-sold construction loans and statutory multifamily mortgages	50% or 100%	Maintains the same risk weights of 50% or 100%, but provides expanded definitions for qualifying assets.
High volatility commercial real estate exposures	150%	Increases the risk weight from 100% and expands the definition for qualifying assets.
Loans over 90 days past due (excluding residential mortgages which are addressed separately)	150%	Increases the current risk weight, which ranges from 50% to 150%, except in situations where qualifying collateral and/or guarantees are in place.
Other assets (including consumer loans)	0% to 250%	Generally consistent with the current risk-based capital rules, with carve outs for certain higher risk exposures.
Off-balance sheet items	0% to 100% Based on CCF	Increases the Credit Conversion Factor (CCF) for certain transaction types and provides expanded definitions for qualifying exposures.

Over-the-counter (OTC) derivative contracts

The treatment of OTC derivatives will be retained from the general risk-based capital rules. The proposed revisions to the treatment of OTC derivatives contracts include an updated definition of an OTC derivative contract; a revised conversion factor matrix for calculating potential future exposure (see Appendix C); a revision of criteria for recognizing the netting benefits of qualifying master netting agreements and of financial collateral; and the removal of the 50% risk weight limit for OTC derivative contracts.

Under the proposed rule, the definition of derivative contract will include: interest rate, exchange rate, equity, credit, or commodity derivative contracts; other instruments that pose similar counterparty credit risks; and unsettled securities; commodities; and foreign exchange transactions (with a contractual settlement or delivery lag that is longer than the lesser of the market standard for the particular instrument or five business days).

For a single OTC derivative contract that is not subject to a qualifying master netting agreement, the exposure amount will be the sum of the current credit exposure and potential future exposure (PFE). In line with the Current Exposure Method under Basel II, PFE is calculated by multiplying the notional principal amount of the OTC derivative contract by the appropriate conversion factor. For multiple OTC derivative contracts subject to a qualifying master netting agreement, the exposure amount will be calculated by adding the net current credit exposure and the adjusted sum of the PFE amounts for all OTC derivative contracts subject to the qualifying master agreement.

Cleared transactions

Under the proposal, a banking organization will be required to hold risk-based capital for all of its cleared transactions, both when acting as a clearing member or as a client of a clearing member. In contrast to the general risk-based capital rules, and as proposed by Basel III, the Agencies will require a banking organization to hold risk-based capital for an outstanding derivative contract or a repo-style transaction cleared through a Central Counterparty (CCP). Under the proposed rule, risk weights for cleared transactions are a function of whether the banking organization is acting as a clearing member or a clearing member client. The exposure to qualifying CCPs are risk weighted at 2% for organizations acting as clearing members and at either 2% or 4% if the organization is a clearing member client (dependent upon collateral arrangements).

The NPR proposes to establish a risk-sensitive approach for risk weighting a banking organization's exposure to a default fund. Under the proposal, the RWA for these exposures will vary depending upon how the funded portion of the default fund compares to the hypothetical capital for the fund calculated using a methodology defined in the NPR.

Credit risk mitigation

The NPR continues to recognize the use of credit risk mitigation techniques as a desired and encouraged approach for banking organizations to reduce, or transfer to a third party, a portion of their credit risk exposures. The NPR considers four forms of risk mitigation, as follows:

- Guaranteed Transactions: Exposures guaranteed by a qualified third party
- Hedged Transactions: Exposures offset by the purchase of a credit derivative
- Collateralized Transactions: Loans secured by first priority claims, cash or qualified securities
- Netted Transactions: Exposures offset by other transactions contemplated under a netting agreement

Guaranteed transactions. The general risk-based capital rules allow recognition of third-party guarantees provided by central governments, GSEs, PSEs in OECD countries, multilateral and regional development banks, US depository institutions, foreign banks, and qualifying securities firms in OECD countries. The NPR has further expanded the range of eligible guarantors to include any guarantor, other than a special purpose entity or credit insurance provider, who is deemed to be an investment grade unsecured debt security issuer, and whose creditworthiness is not positively correlated with the credit risk of the exposures for which it has provided guarantees.

Hedged transactions. Eligible credit derivatives must be in the form of a credit default swap, n^{th}-to-default swap, total return swap, or any other form of credit derivative specifically approved by the primary federal supervisor. The NPR also provides a series of additional conditions that must be met for derivatives, as well as guarantees, to be considered as eligible.

The substitution approach under the NPR allows banking organizations to "substitute" the risk weight applicable to the guarantor or credit derivative protection provider for the risk weight assigned to the hedged position. In cases where there is a mismatch in exposure amounts, currencies, maturities or other specified criteria, formal business rules and methodologies have been laid out to adjust or "haircut" the risk mitigating value of the credit enhancement.

Collateralized transactions. The regulators have recognized that current eligibility requirements for acceptable collateral are inconsistent with market practices and standards articulated in the Basel II capital framework. As such, the definition of eligible "financial collateral" has been expanded to encompass the following:

- Cash on deposit with the banking organization (or held by a 3rd party custodian or trustee)
- Gold bullion
- Investment grade short and long-term debt securities (excluding resecuritization exposures)
- Equity securities that are publicly traded
- Convertible bonds that are publicly traded
- Money market and other mutual fund shares (if shares prices are publicly quoted daily)

The positive impact on risk weightings derived from financial collateral may be recognized by using the "Simple Risk-Weight Approach." Alternatively, the "Collateral Haircut" approach may be used for repo-style transactions, eligible margin loans, collateralized derivative contracts, and single-product netting sets of such transactions.

The proposed Simple Risk-Weight Approach is relatively consistent with existing rules, and permits the collateralized portion of an exposure be risk-weighted at the rate applicable to the underlying financial collateral, if the banking organization has appropriate legal rights to the collateral, the transactions are in the same currency, the maturity of the collateral agreement exceeds the life of the exposure, and the collateral is revalued every six months. Under this approach, risk weightings can fall to 10% for financial collateral in the form of exposures to sovereigns and related entities that have a 0% risk weighting, and to 0% for cash deposits and OTC derivatives marked and margined daily.

Banking organizations may also use the "Collateral Haircut" approach to define risk weightings for certain transactions. Under this NPR, a banking organization will use an 8% haircut for each currency mismatch and will use the market price volatility haircut appropriate to each security ranging from 0% to 25% (see Appendix G). The NPR provides for adjustment on the holding periods of the haircuts to reflect the different liquidity characteristics of repo-style transactions and collateral deemed illiquid. Banking organizations that demonstrate they have met certain qualitative and quantitative standards may be permitted to derive their own estimates for haircuts.

The NPR does not allow for the use of Simple Value-at-Risk (VaR) to calculate exposure amounts for eligible margin loans and repo-style transactions as it is incorporated in the Standardized Approach under Basel III. The Internal Models Methodology (IMM) permitted under the Advanced Approach is also not currently permitted. However, the agencies are still considering whether to incorporate these methodologies into the final rule for the Standardized Approach.

Unsettled transactions

Under the NPR, it is proposed that a separate risk-based capital requirement be established for transactions involving securities, foreign exchange instruments, and commodities that have a risk of delayed settlement or delivery. Two separate approaches have been outlined, one for delivery-versus-payment (DvP) and payment versus-payment (PvP) transactions with a normal settlement period, and the other for non-DvP and non-PvP transactions.

DvP transactions refer to securities or commodities transactions in which the buyer is obligated to make payment only if the seller has made delivery of the securities or commodities. Delivery and payment are made simultaneously. Similarly, PvP transactions refer to foreign exchange transactions in which delivery of currencies is settled simultaneously.

The NPR requires banking organizations to assign risk-weights to unsettled transactions if the counterparty does not make delivery or payment under the specified times after the settlement date. Deliverables and payments owed would be subject to risk weights from 100% to 1,250% depending upon the counterparty and aging of the transaction.

Securitization exposures

Under the proposed Standardized Approach NPR, the agencies are updating terminology proposing a broader definition of securitization exposures. Additional changes are made to specifically exclude investment funds, pension funds, and investment companies from the definition of a securitization. In doing so, the agencies have specifically stated that managed collateralized debt obligations (CDOs), structured investment vehicles (SIVs), and similar structures are not excluded from the definition of securitizations.

To meet the requirements of Section 939A of the DFA, all references to external credit ratings have been removed, and the risk weights based on external credit ratings no longer exist. Instead, the Simplified Supervisory Framework Approach (SSFA) has been introduced and is only available to banking organizations for which the Advanced Approach and/or the Market Risk Final Rule do not apply. If the SSFA is not applied, a gross-up approach can be used. If neither approach is used, a risk weight of 1,250% is applied, but the chosen securitization approach must be applied consistently across all securitization exposures. As before, different criteria for liquidity facilities and Asset-Backed Commercial Paper (ABCP) also come into play. Regardless, the NPR proposes a minimum 20% risk weight for all securitization exposures.

The major changes to the existing US rules as well as differences with the Basel II standards include the following:

- Revised securitization and resecuritization definitions; as noted above, resecuritizations are also no longer eligible financial collateral.
- Elimination of external credit ratings resulting in the elimination of a number of approaches permitted under Basel II, creating a new hierarchy of approaches.
- Stringent due diligence requirements demonstrating a “comprehensive understanding” both at origination and on an ongoing periodic basis, at least quarterly, rather than relying solely on external ratings.
- Increased operational requirements for both traditional and synthetic securitizations.
- Increased disclosure requirements (see Pillar 3 disclosures, and market discipline and disclosure requirements below).

There are a number of definitions, many of which carry over from existing rules, covering the following:

- The exposure amount of a securitization is either the carrying value of the on-balance sheet exposure or the notional value of the off-balance sheet exposures.
- Eligible ABCP liquidity facilities have CCFs of 50% if the SSFA is applicable or 100% otherwise. Gain-on-Sale and Credit-enhancing Interest-only Strips (CEIOs) are deducted or given a 1,250% risk weight.
- Exceptions apply for interest-only mortgage backed securities (100% risk weight), small business loans, and OTC derivatives with 1st priority claims on cash flows from the underlying exposures.
- Overlapping exposures are no longer double counted; instead the higher risk weight applies.
- Servicer cash advances are now considered securitization exposures.

- Implicit support, above and beyond contractual obligations, will require assets to be risk weighted as if they were not securitized and carry additional disclosure requirements.

The SSFA approach is based on a formula that takes into account significant delinquencies on underlying assets and adjusts the capital requirement up or down as a function of these delinquencies. The revised formula provides for higher risk sensitivity as it requires more capital to be held against junior tranches relative to senior tranches. In addition, the revised formula is more forward-looking, as it adjusts capital requirements using delinquencies rather than losses. To prevent capital arbitrage between the credit and market risk rules, the base capital requirement for underlying exposures may not be lower than the weighted average capital requirement of the underlying exposures under the general risk-based capital rules. Additional enhancements to the SSFA calculation include the recognition of relative seniority of position and cash funded enhancements.

As an alternative to the SSFA, banking organizations may use the gross-up approach. In doing so, the gross-up approach will be required for all securitizations except where an alternative treatment is allowed. The gross-up approach requires four inputs:

- The pro-rata share of the banking organization's securitization exposure
- The enhanced amount, which is the value of tranches senior to the tranche of the banking organization's exposure
- The exposure amount of the banking organization's securitization exposure
- The weighted-average risk weight of the underlying exposures in the securitization pool

Alternative approaches to the 1,250% risk weight exist for eligible ABCP programs and securitization exposures that are in a second loss position or better to an ABCP program.

Credit risk mitigation for securitization exposures will generally follow the rules laid out in the Standardized Approach NPR for financial collateral, eligible guarantees, and eligible credit derivatives. To recognize the benefits of risk mitigation through an nth-to-default credit derivative, a bank can use the SSFA or use a 1,250% risk weight. As has been the case under Basel II rules, recognition of the benefits of a second or subsequent to default is obtainable only if a 1st to default through (n-1) default credit derivative is also present or if n-1 of the underlying exposures has already defaulted.

Equity exposures

The Agencies are proposing a significant change to the manner in which banking organizations determine the appropriate risk weight to be applied to equity exposures. In particular, it is proposed that the Simple Risk Weight Approach (SRWA) be used for all equity exposures with the exception of investment funds that will require the application of certain look-through treatments. In addition, a distinction will now be made between publically traded and non-publically traded equity exposures.

Under the proposal, a banking organization will be required to determine the adjusted carrying value for all on-balance sheet and off-balance sheet equity exposures. The adjusted carrying value of an on-balance sheet exposure is simply the carrying value of that exposure. However, off-balance sheet exposures are determined based on the application of a conversion factor that considers the nature of the exposure, its conditionality, and its duration/maturity. For equity exposures that form an effective hedge as defined in the NPR, banking organizations may risk weight only the effective and ineffective portions of the hedge pair.

Once the adjusted carrying value is established, the risk weights summarized in Table 2 below will be used to determine the RWA amount for each equity exposure.

Table 2. Summary of risk weights for equity exposures

Risk weight	Type of applicable equity exposure
0%	An equity exposure to a sovereign, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, an MDB, and any other entity whose credit exposures receive a 0% risk weight under the NPR
20%	An equity exposure to a PSE, Federal Home Loan Bank or the Federal Agricultural Mortgage Corporation (Farmer Mac)
100%	• Community development equity exposures • The effective portion of a hedge pair • Non-significant equity exposures to the extent that the aggregate adjusted carrying value of the exposures does not exceed 10 percent of tier 1 capital plus tier 2 capital
250%	A significant investment in the capital of an unconsolidated financial institution that is not deducted under section 22 of the proposal
300%	A publicly traded equity exposure (other than an equity exposure that receives a 600% risk weight and including the ineffective portion of a hedge pair)
400%	An equity exposure that is not publicly traded (other than an equity exposure that receives a 600% risk weight)
600%	An equity exposure to an investment firm that (i) would meet the definition of a traditional securitization were it not for the primary federal supervisor's application of paragraph (8) of that definition and (ii) has greater than immaterial leverage

For equity exposures to investment funds, the current general risk-based capital rules allow exposures to be captured through one of two methods that are consistent with the Alternative Modified Look-through Approach and the Simple Modified Look-through Approach proposed in the NPR. In addition, the Agencies have proposed that the Full Look-through Approach be made available as an additional option under the Standardized Approach. See Appendix D for a summary of the three alternative approaches.

Insurance-related activities

As previously noted, the standards detailed in this NPR are intended to apply consolidated capital requirements to SLHC, consistent with the requirements of the DFA. As SLHC have never before been subject to consolidated quantitative capital requirements, certain characteristics of their business, most notably nonbank exposures, require special consideration from a risk-based capital perspective.

The NPR defines risk weights for policy loans, separate accounts, Deferred Acquisition Costs (DCAs) and Value of Business Acquired (VOBA). The descriptions and proposed requirements of these exposures, unique to SLHC as well as certain BHCs, are summarized in Appendix E. In addition, certain financial obligations or balance sheet items traditionally considered to be a component of capital for statutory accounting purposes require special treatment for risk adjusted capital purposes. Specifically, the proposal modifies the treatment of surplus notes and Insurance Underwriting Subsidiaries as summarized in Appendix F.

Risk weighted assets under advanced approaches

The Advanced Approaches NPR will be applicable to banking organizations with consolidated assets greater than or equal to $250 billion, or with total consolidated on-balance sheet foreign exposures of at least $10 billion. Consistent with Basel III, the Advanced Approaches NPR introduces regulatory capital requirements for counterparty credit risk, credit valuation adjustments, wrong-way risk, as well as a more risk-sensitive approach for capitalization of exposures to central counterparties. In addition, the NPR incorporates the changes in the capital requirements for securitization exposures proposed under Basel 2.5. Finally, the NPR makes changes consistent with section 939A of DFA, which requires the removal of references to external credit ratings and rating agencies.

Counterparty credit risk

The counterparty credit risk (CCR) requirements under the Advanced Approaches NPR are generally in line with Basel III. However, the NPR provides alternatives to external credit ratings to ensure compliance with section 939A of the DFA. The NPR modifies the CCR approach with respect to: the recognition of financial collateral; holding periods and the margin period of risk; use of stressed inputs within the Internal Model Methodology (IMM); incorporation of credit valuation adjustments (CVA); treatment of centrally cleared transactions; and inclusion of stressed periods within internal estimates.

Recognition of financial collateral. The framework of the proposed rules will allow banking organizations to recognize credit mitigation benefits of financial collateral collected from counterparties. Consistent with Basel III, the proposal excludes resecuritizations, conforming residential mortgages, and all debt securities that are not investment grade from the adjustment to Exposure at Default (EAD).

Revised supervisory haircuts. Supervisory haircuts are revised to reflect the applicable risk-weight of the exposure under the Standardized Approach. This new approach, which includes haircuts for securitizations, is consistent with DFA section 939A in that it substitutes references to external credit ratings with the corresponding methodologies defined under the Standardized Approach. See Appendix G for details.

Holding periods and margin period of risk. The changes to the holding periods and margin periods of risk within the proposal are generally consistent with Basel III and will apply to repo-style transactions, OTC derivative transactions and eligible margin loans. Cleared transactions will not be subject to these changes. Under the new proposal, the holding period for the collateral haircut and simple VaR approaches will be raised to 20 days. The margin period of risk within the IMM will also be raised to 20 days for netting sets with over 5,000 trades, netting sets that involve illiquid collateral, or netting sets that involve OTC contracts that are not easily replaceable. The guidelines to define these last two conditions are based on the banking organization's ability to obtain multiple quotes within two days or less, and on whether or not these quotes would have an impact on the market or represent a market discount or premium. The proposal also requires that the margin period of risk be raised in the presence of margin disputes.

Internal models methodology. The proposal also changes how banking organizations will calculate the capital requirement for IMM exposures. IMM exposures are defined as repo-style transactions, eligible margin loans, or OTC derivatives for which the banking organization calculates EAD using IMM. The new rule will require banking organizations to use the larger of either the capital requirement based on the most recent three-year period or the capital requirement based on a three-year period that contains a period of stress. The

Advanced Approaches NPR also implements the Basel III modification to the shortcut method of recognizing collateral benefits.

Wrong-way risk. The NPR defines specific wrong-way risk as the situation in which the counterparty and issuer of the collateral posted for the transaction, or the counterparty and the reference asset of the transaction, are affiliates or are the same entity. For these types of transactions, the NPR provides a table of risk-based capital formulas by transaction type for which the probability of default of the counterparty and a loss given default of 100% should be applied. The output of the formula is then multiplied by an EAD calculation that is also determined by the transaction type.

Asset value correlation factor. To account for positive correlations, the proposal requires a 1.25x AVC multiplier applied to exposures to unregulated financial institutions and financial institutions with consolidated assets greater than or equal to $100 billion. The proposed rule also attempts to strengthen the governance of the IMM by requiring enhancements to model validation and collateral management policies.

Credit valuation adjustments. The NPR requires a new capital requirement that reflects the changes in CVA due to changes in credit spreads of counterparties. The Agencies are proposing to adopt the Basel III simple and advanced CVA approaches with a modification to exclude references to credit ratings. The advanced CVA approach is only available to banking organizations subject to the Market Risk Capital Rule with an approved model for OTC derivatives exposures. The Advanced Approach will use the banking organization's eligible VaR model to determine the impact of changes in the counterparty's credit spreads and take this in conjunction with recognized CVA hedges to determine the CVA for that counterparty. To calculate the equivalent RWA amount, the CVA capital requirement would be multiplied by 12.5 and would not be subject to the 1.06 multiplier for credit RWA.

For the simple CVA approach, the Basel III formula will be adopted with a small modification to comply with the requirements of section 939A of the DFA.

Cleared transactions. To recognize systemic risk associated with the central clearing of potentially large volumes of derivatives, a risk weight will be applied to exposures to qualified CCPs in conjunction with a capital requirement for default fund contributions. This is a change from the previous requirement of 0 % risk weight for qualified CCPs. For cleared derivative contracts or repo-style transactions, the exposure will be equal to the exposure calculated using the methodology for these instruments outlined in the NPR, plus the fair value of the collateral posted by the banking organization. For EAD calculations with the IMM, banking organizations would use the most recent three years of historical data. For clearing members, a 2% risk weight will be applied to the trade exposure if the posted collateral is protected from losses due to CCP or clearing member default and a sufficient legal review concludes that the protections would be upheld. If these conditions are not met, a risk weight of 4% will be used. Exposures to unqualified CCPs will be treated in accordance with the Standardized Approach. Capital requirements for default fund contributions will be calculated with the Standardized Approach and must be completed at least quarterly.

Stress periods for internal estimates. The proposed rule modifies the calculations of market price and foreign exchange volatility under the collateral haircut approach by requiring banking organizations use a historical observation period of 12 continuous months of significant financial stress in determining their internal estimates of haircuts.

Securitization exposures

The Advanced Approaches NPR makes a number of significant changes around securitization exposures:

- The definition of a securitization is broadened to "include any exposure that directly or indirectly references a securitization exposure." Resecuritization exposures are also more clearly defined.
- As noted under the Standardized Approach discussion, further changes were made to specifically exclude investment funds, pension funds, and investment companies from the definition of a securitization.
- As is the case under the Standardized Approach, to comply with Section 939A of the DFA, the use of external credit ratings is no longer permitted. This has the effect of replacing the Standardized Approach with the Simplified Supervisory Approach (SSFA), eliminating the Ratings Based Approach (RBA) and the Internal Assessment Approach (IAA), and requiring modification to a number of areas where investment grade and/or non-investment grade were defined by mapping to external rating agency scales.
- The changes noted above have the effect of creating a new hierarchy of approaches which can be simplified as follows:
  1. Deduction for after-tax gain on sale or 1,250% risk weight for CEIOs
  2. Use of the Supervisory Formula Approach (SFA); the Agencies expect all banking organizations to use this methodology in all instances where data is available
  3. Use of the SSFA but requiring justification of why the SFA cannot be used
  4. If none of the above approaches can be used the exposures are assigned a risk weight of 1,250%
- Many exposures previously subject to deduction, CEIOs and, low-rated securitization exposures (below BB), will now be assigned a 1,250% risk weight rather than be deducted from capital to be consistent with Basel III.

The SFA is essentially the same as proposed under Basel II with the exception of an increased floor at 1.6% compared to 0.56% in Basel II and Basel 2.5[2] and requires the institution to use explicit formulas based upon inputs (parameters) from the underlying collateral pool. Compared to its simplified counterpart SSFA, SFA is generally more risk sensitive than SSFA as a result of the more granular inputs/parameters into the formula (e.g., capital requirement for the underlying pool, etc.). Both formulae determine a securitization exposure's risk weight based on the underlying assets and exposure's relative position in the capital structure. As a result, for US banking organizations that are currently under ratings-based approach, adoption of SFA or SSFA will have different capital impacts on their securitization portfolio across the spectrum of ratings and capital structures (e.g., increased capital charges for AAA bonds due to the SFA/SSFA floor, while less capital required for senior/mezzanine tranches rated single B or lower that are currently subject to deduction, etc.).

The Agencies have also clarified how to calculate RWA for guarantees or non nth-to-default credit derivatives referencing a securitization exposure, which was an omission in the original US Final Rule. RWA are calculated as if the banking organization directly holds the exposure using either the SFA, SSFA or if neither of these are possible a 1,250% risk weight. For protection purchased for a securitization exposure, eligible guarantees would be

[2] Resecuritizations have a floor of 1.6% in Basel 2.5, aligned with the floor under RBA.

recognized through PD substitution, LGD adjustment or applying double default treatment to the exposure.

Due diligence requirements under the Advanced Approach are consistent with those outlined in the Standardized Approach NPR.

Market risk final rule

The Agencies approved the final Market Risk Final Rule (Final Rule) to implement changes to the Market Risk Capital Rule that requires banking organizations with significant trading activities adjust their capital requirements to better account for the market risks of those activities. The Final Rule implements certain revisions made by the BCBS to its market risk framework between 2005 and 2010. The Market Risk Final Rule looks to refine the scope of covered positions, increase the risk sensitivity of the capital requirements, and increase transparency through enhanced disclosures. The Final Rule includes specific guidance around the quantitative aspects to calculating market risk capital and also addresses many of the qualitative aspects around market risk governance, oversight and disclosures.

The Final Rule does not include those aspects of Basel 2.5 that rely on external credit ratings to meet the requirements of DFA section 939A. Instead, the Final Rule includes alternative standards of creditworthiness for determining specific risk-based capital requirements for certain debt and securitization positions. The Final Rule applies to bank holding companies and state-chartered banks that are members of the Federal Reserve System. Separately, the Board proposed to apply the Market Risk Capital Rule to SLHCs that meet the thresholds described in the Final Rule.

Key elements of the Market Risk Final Rule include:

- Updated definitions for covered positions that place greater emphasis on trading purpose.
- Standards for use of internal models for Value-at-Risk (VaR) calculations and Stressed VaR in market risk capital calculations including treatment of credit spread risk, correlations within and across risk categories, as well as risks arising from the nonlinear price movements.
- Standards for specific risk capital requirements including use of internal models and application of specific risk add-on factors.
- An incremental risk capital requirement that addresses default risk and migration risk.
- A comprehensive risk capital requirement to measure comprehensive price risk for correlated trading activities.
- Disclosure requirements including qualitative information on a banking organization's market risk modeling methodologies and quantitative disclosures relating to a banking organization's risk measures for each material portfolio of covered positions.
- The Market Risk Final Rule will be effective on January 1, 2013.

Covered positions

The Market Risk Final Rule places greater emphasis on the purpose of the trade as a key component of what defines a covered position. The rule defines a "trading position" as trading assets or trading liabilities held for the "purpose of short-term resale or with the intent of benefiting from actual or expected short-term price movements or to lock in

arbitrage profits" and clarifies that the US GAAP definition of a trading position will not necessarily be consistent with the Market Risk Final Rule. The rule defines covered positions to include on and off-balance sheet trading assets and liabilities that are trading positions or hedges on a covered position and are free of tradability restrictions as well as foreign exchange or commodity position regardless of whether the position is a trading asset or trading liability. The definition of covered position excludes: intangible assets; certain positions that do not meet the hedging strategy criteria above; positions that act as a liquidity facility supporting ACBP; credit derivatives recognized as guarantees for RWA purposes; equity positions that are not publicly traded, other than a derivative that references a publicly traded equity; securitization inventory; or direct real estate holdings.

A banking organization is expected to have well-defined internal procedures to identify the positions that are considered trading positions and correlation trading positions. Trading and hedging strategies for trading positions must be approved by senior management at the banking organization. A banking organization is also required to have well defined internal procedures for actively managing all covered positions, which include: procedures related to daily marking of positions; actively hedging covered positions; establishing and monitoring risk limits; and periodically reviewing valuation inputs and assumptions.

In an effort to reduce any inconsistencies and the perception of regulatory arbitrage between the final market risk capital rule and the proposed Volcker rule, the final market capital rule notes that covered positions will generally be subject to the Volcker rule. However, foreign exchange or commodity positions, that will not be subject to the definition of a trading account under the proposed Volcker rule or qualify for other exemptions proposed under the Volcker NPR, will be the exceptions.

Capital requirement for market risk

The Market Risk Final Rule requires that a banking organization calculate its risk-based capital ratio denominator as the sum of its adjusted RWA and market risk equivalent assets. However, Advanced Approaches organizations will be required to calculate both a general risk-based capital requirement as well as an advanced risk-based capital requirement. Each measure of market risk (general or advanced) will need to be multiplied by 12.5 to determine its market risk equivalent assets. The Market Risk Final Rule proposes that general and advanced measures for market risk total the sum of its components including: (Value-at-Risk based capital requirement) + (Stressed Value-at-Risk based capital requirement) + (Specific risk capital charge) + (Incremental risk capital requirement) + (Comprehensive risk capital requirement) + (Capital charge for de minimis exposures).

Each of these components will be calculated according to the specific guidance and methodologies provided in the Market Risk Final Rule.

VaR and Stressed VaR capital requirement

The Market Risk Final Rule requires a banking organization to use an internal model to calculate its VaR-based capital requirement on a daily basis for all covered positions (consistent with guidance proposed in the rule including multiplication factors based on back-testing results). In addition, banking organizations will be required to calculate the VaR-based capital requirement in a stressed market environment, at a minimum on a weekly basis. The banking organization's VaR-based measure will include risk factors such as credit spread risk, correlations within and across risk categories, as well as risks arising from the nonlinear price movements inherent in positions with optionality. A banking

organization must also be able to justify to its regulator the omission of any risk factors from its VaR methodology and demonstrate the appropriateness of any proxies used.

Consistent with the Proposed Market Risk Rule, the VaR methodology will be calculated using a one-tail, 99% confidence level; a ten-business-day holding period, and a historical observation period of at least one year. Calculation of the stressed VaR-based measure requires that banking organizations use that same VaR model, but with model inputs calibrated based upon historical data during a one-year period of significant financial stress appropriate to the banking organization's current portfolio.

The rule recognizes the implementation challenges and burden that the new back-testing requirements may impose on banking organizations. Thus, banking organizations will be allowed up to one year after the later of either January 1, 2013 or the date that the banking organization becomes subject to the rule, to comply with the back-testing requirements.

Modeling standards for specific risk

A banking organization will be expected to have well-defined processes to identify covered positions that have specific risk. Banking organizations are permitted to use an internal model(s) to measure specific risk for covered positions including debt and equity positions consistent with the requirements detailed in the rule. However, use of an internal model to measure specific risk for correlation positions is required, except for securitizations.

For banking organizations that do not have a VaR-based model sufficient to address specific risk and for securitizations other than correlation positions, the standardized method for calculating specific risk must be used. Under the standardized method, a specific risk-add on must be applied using prescribed risk weight factors for various asset classes including sovereign debt, certain supranational entity and multilateral development bank debt positions, government sponsored entity debt, depository institution, foreign bank, and credit union debt positions, public sector entity debt positions, corporate debt and securitization positions.

The rule also emphasizes the need for banking organizations to perform their own due diligence on credit worthiness. Application of these standardized risk weight factors is consistent with the requirements of the DFA section 939A.

Incremental risk capital requirement

A banking organization that calculates the specific risk for debt positions using an internal model must also calculate a measure of incremental risk (a measure of default risk and credit migration risk of a position) no less frequently than weekly. The model must calculate incremental risk over a one-year time horizon using a one-tail, 99.9% confidence level, and using an assumption of either a constant level of risk or of constant positions. In addition, the model must incorporate a liquidity horizon consistent with the time that would be required for a banking organization to reduce its exposure to, or hedge all of its material risk to the position in a stressed market. The liquidity horizon prescribed in the Market Risk Final Rule may not be less than the shorter of three months or the contractual maturity of the position.

Additionally, the banking organization's incremental risk methodology must incorporate nonlinear risk with respect to default and credit migration, and be consistent with its internal risk management methodologies and processes.

Comprehensive risk capital requirement

Banking organizations must calculate a comprehensive risk measure to measure all material price risk for portfolios of correlation trading positions. In addition, banking organizations will be required to apply a specific set of supervisory stress scenarios to its portfolios of correlation trading positions no less frequently than weekly.

Banking organizations that receive prior approval from its primary federal supervisor may use an internal, comprehensive risk model provided that the model addresses all material price risks, requirements around time horizon and confidence level, and assumptions around constant position risk and liquidity assumptions. If the banking organization does not use a comprehensive risk model to measure price risk in correlation positions, it must apply a specific risk add-on using the Standardized Measurement Method.

Banking organizations must initially calculate the comprehensive risk measure under a surcharge approach equal to the sum of the output from the banking organization's approved comprehensive risk model plus a surcharge on the banking organization's modeled correlation trading positions. Over time, however, as banking organizations and supervisors become more familiar with the model, a banking organization may be permitted to use a floor approach to calculate comprehensive risk capital using the greater of the output from the banking organization's approved comprehensive risk model or 8.0% of the total specific risk add-on that would apply under the standardized measurement method for specific risk.

Pillar 3 disclosures, market discipline and disclosure requirements

The NPRs introduce disclosure requirements with the objective of improving market discipline and encouraging sound risk management in banking organizations. The public disclosure requirements apply only to banking organizations with $50 billion or more in consolidated assets. Organizations may be able to fulfill proposed disclosure requirements by using information provided in regulatory reports or similar disclosures made in accordance with accounting standards or SEC mandates. Any material differences between these disclosures and the disclosures required under the NPR will need to be explained.

The NPR establishes minimum frequency and timing requirements for public disclosures. Generally, banking organizations will be required to make quarterly and annual disclosures of quantitative and qualitative information in line with Pillar 3. Disclosures will have to be publicly available for each of the prior three years or for a shorter time period beginning when the proposal comes into effect. The proposal also requires that the Board of Directors of the organization approve a formal public disclosure policy, as well as annual confirmation by senior officials that disclosures meet the requirements of the rule.

The proposed disclosures include both qualitative and quantitative representations in the areas of capital structure, capital adequacy, capital conservation buffer, credit risk, counterparty credit risk, credit risk mitigation, securitizations, equities not subject to the standardized approach, and interest rate risk for non-trading activities. As part of Pillar 3 requirements, the agencies have expanded the disclosure requirements for securitization exposures. These disclosures include: details on the nature of the securitization risks; policies that monitor changes in credit and market risk and the use of credit risk mitigation for securitization exposures; summaries of the banking organization's accounting policies for securitization activities; and a list of the special purpose entities and affiliated entities

linked to securitization exposures. Disclosure requirements related to the use of credit ratings have not been included to conform to the requirements of DFA. In addition, the Agencies have refined the requirement that banking organizations provide disclosures of accounting and valuation policies for equity holdings in the banking book. The Agencies have proposed that banking organizations provide disclosures only for equity holdings that are not covered positions.

Appendix A. Transitional arrangements (shading indicates transition periods)

	Jan 1, 2013	Jan 1, 2014	Jan 1, 2015	Jan 1, 2016	Jan 1, 2017	Jan 1, 2018	Jan 1, 2019
Minimum CET1 Ratio	3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer				0.625%	1.25%	1.875%	2.5%
Minimum CET1 ratio + conservation buffer	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Minimum Tier 1 Capital	4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer	8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Minimum Supplementary Leverage Ratio			Disclosure starts 1 Jan 2015			3.0%	3.0%
Minimum Tier1 Leverage Ratio	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)		20%	40%	60%	80%	100%	100%

Appendix B. Proposed FDIC Prompt Corrective Action levels

PCA Levels for insured depository institutions not subject to Advanced Approaches rule

Requirement	Total RBC measure (total RBC ratio – %)	Tier 1 RBC measure (tier 1 RBC ratio – %)	Common Equity tier 1 RBC measure (common equity tier 1 RBC ratio – %)	Leverage measure (leverage ratio – %)	PCA requirements
Well capitalized	≥ 10	≥ 8	≥ 6.5	≥ 5	Unchanged from current rules
Adequately capitalized	≥ 8	≥ 6	≥ 4.5	≥ 4	
Undercapitalized	< 8	< 6	< 4.5	< 4	
Significantly undercapitalized	< 6	< 4	< 3	< 3	
Critically undercapitalized	Tangible Equity (defined as tier 1 capital plus non-tier 1 perpetual preferred stock) to Total Assets ≤ 2				

PCA Levels for insured depository institutions subject to Advanced Approaches rule

Requirement	Total RBC measure (total RBC ratio – %)	Tier 1 RBC measure (tier 1 RBC ratio – %)	Common Equity tier 1 RBC measure (common equity tier 1 RBC ratio – %)	Leverage measure Leverage Ratio (%)	Leverage measure Supplementary Leverage ratio (%)	PCA requirements
Well capitalized	≥ 10	≥ 8	≥ 6.5	≥ 5	Not applicable	Unchanged from current rules
Adequately capitalized	≥ 8	≥ 6	≥ 4.5	≥ 4	≥ 3	
Undercapitalized	< 8	< 6	< 4.5	< 4	< 3	
Significantly undercapitalized	< 6	< 4	< 3	< 3	Not applicable	
Critically undercapitalized	Tangible Equity (defined as tier 1 capital plus non-tier 1 perpetual preferred stock) to Total Assets ≤ 2				Not applicable	

Appendix C. Conversion factor matrix for OTC derivative contracts

Remaining maturity	Interest rate	Foreign exchange rate and gold	Credit (investment-grade reference asset)	Credit (non investment-grade reference asset)	Equity	Precious metals (except gold)	Other
≤ 1 year	0.00	0.01	0.05	0.10	0.06	0.07	0.10
> 1 year and ≤ 5 years	0.005	0.05	0.05	0.10	0.08	0.07	0.12
> 5 years	0.015	0.075	0.05	0.10	0.10	0.08	0.15

Appendix D. Look-through approaches for equity exposures held by investment funds

Approach	Description
Full Look-Through Approach	This approach may be utilized in those cases where the banking organization is able to calculate a risk-weighted asset amount for each of the exposures held by the investment fund (as if the exposures were held directly by the banking organization). The banking organization's RWA amount for the fund would be equal to the aggregate RWA amount of the exposures held by the fund multiplied by the banking organization's proportional ownership share of the fund.
Simple Modified Look-Through Approach	The risk weighted asset amount for an equity exposure to an investment fund will be equal to the adjusted carrying value of the equity exposure multiplied by the highest risk weight assigned to any exposure the fund is permitted to hold under the prospectus, partnership agreement, or similar agreement that defines the fund's permissible investments. Excluded from this calculation are any derivative contracts held by the fund that are used for hedging, rather than for speculative purposes, and that do not constitute a material portion of the fund's exposures.
Alternative Modified Look-Through Approach	The adjusted carrying value of an equity exposure to an investment fund may be assigned on a pro rata basis to different risk weight categories based on the investment limits detailed in the fund's prospectus, partnership agreement, or similar contract that defines the fund's permissible investments. The resulting RWA amount would be equal to the sum of each portion of the adjusted carrying value assigned to an exposure type multiplied by the applicable risk weight. If the sum of the investment limits for all exposures within the fund exceeds 100%, it would be assumed that the fund invests to the maximum extent permitted under its investment limits in the exposure type with the highest applicable risk weight and would continue to make investments in the order of the exposure category with the next highest risk weight until the maximum total investment level is reached. If more than one exposure category applies to an exposure, the highest applicable risk weight will be used. Excluded from this calculation are any derivative contracts held by the fund that are used for hedging, rather than for speculative purposes, and that do not constitute a material portion of the fund's exposures.

Appendix E. Risk weights for insurance-related exposures

Asset type	Description	RWA %
Policy loans	Loans to policyholders under an insurance contract that are secured by the cash surrender value or collateral assignment of the related policy or contract, including: (1) a cash loan, including a loan resulting from early payment or accelerated payment benefits, on an insurance contract when the terms of contract specify that the payment is a policy loan secured by the policy; and (2) an automatic premium loan, which is a loan made in accordance with policy provisions that stipulate that delinquent premium payments are automatically paid from the cash value at the end of the established grace period for premium payments.	20%
Separate accounts	A legally segregated pool of assets owned and held by an insurance company and maintained separately from its general account assets for the benefit of an individual contract holder, subject to certain conditions. Four additional requirements must be met in order to qualify, including 1) legal recognition; 2) segregation from the insurer's liabilities; 3) self directed investing; and 4) all gains and loss pass to the policy holder. Special treatment is provided for non-guaranteed accounts. To qualify, the insurance company cannot contractually guarantee a minimum return or account value to the contract holder, and the insurance company would not be required to hold reserves for these separate account assets.	0% for Non-Guaranteed For Guaranteed-RWA based on the underlying asset type
Deferred Acquisition Costs (DCAs) & Value of Business Acquired (VOBA)	DACs represent certain capitalized costs incurred to acquire or renew an insurance contract. VOBAs refer to assets that reflect revenue streams from insurance policies purchased by an insurance company.	100%

Appendix F. Treatment of certain capital components of insurance companies

Instrument	Description	Proposed treatment
Surplus notes	Financial instruments issued by an insurance company that are included in surplus for statutory accounting purposes. The following features typically apply: (1) advance approval from the state insurance regulator relative to the note's form and content, (2) fully subordinated and (3) prior approval by the state insurance regulator for any related interest payments and principal repayments.	Excluded from Tier 1 Capital, but may be eligible for inclusion in Tier 2 capital provided the note meets all eligibility criteria. A transition provision is provided in the Basel III NPR for instruments that would no longer meet the eligibility criteria for Tier 2 capital.
Insurance underwriting subsidiaries	Bank holding companies and savings and loan holding companies typically maintain as part of total capital a minimum regulatory capital amount related to their insurance underwriting subsidiaries (generally 200% of the subsidiary's authorized control level).	50% of the consolidated required capital amount related to insurance underwriting subsidiaries will be deducted from Tier 1 capital and 50% from Tier 2 capital.

*Appendix G. Standard supervisory market price volatility haircuts**

Residual maturity	Sovereign issuers ** that receive a 0% risk weight (in %)	Sovereign issuers that receive a 20% or 50% risk weight (in %)	Sovereign issuers that receive a 100% risk weight (in %)	Non-sovereign issuers that receive a 20% risk weight (in %)	Non-sovereign issuers that receive a 50% risk weight (in %)	Non-sovereign issuers that receive a 100% risk weight (in %)	Investment grade securitization exposures (in %)
Less than 1 year	0.5	1.0	15.0	1.0	2.0	25.0	4.0
Greater than 1 year and less than 5 years	2.0	3.0	15.0	4.0	6.0	25.0	12.0
Greater than 5 years	4.0	6.0	15.0	8.0	12.0	25.0	24.0
Main index equities (including convertible bonds) and gold					15.0		
Other publicly traded equities (including convertible bonds)					25.0		
Mutual funds				Highest haircut applicable to any security in which the fund can invest.			
Cash collateral held					0.0		

* The market price volatility haircuts in this table are based on a ten-business-day holding period. A banking organization must adjust the supervisory haircuts upward on the basis of a holding period longer than ten business days (for eligible margin loans) or five business days (for repo-style transactions) where certain conditions are met.
** Includes a foreign public-sector entity that receives a 0% risk weight.

Additional information

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