

March 30, 2012

This is the final in a two part series of alerts on investment securities and risk-based capital requirements under Dodd Frank. The first alert focused on the new creditworthiness standard released by the OCC that was designed to replace credit ratings. This alert focuses on the recent progress report to the US Senate Banking Committee by the Federal Reserve, the FDIC, the OCC, the SEC, the CFTC and the Treasury, the Federal Reserve's enhanced prudential supervision proposal, the joint notice of proposed rulemaking released by the OCC, the Federal Reserve and the FDIC primarily covering market risk capital requirements and alternatives to credit ratings for debt and securitization positions, and the capital requirements of the Basel Committee on Bank Supervision.

Congressional Update on International Harmonization Efforts

On March 22, 2012, representatives from the US Department of the Treasury ("Treasury"),¹ the Board of Governors of the Federal Reserve System (the "Federal Reserve"),² the US Securities and Exchange Commission (the "SEC"),³ the Federal Deposit Insurance Corporation (the "FDIC"),⁴ the Office of the Comptroller of the Currency (the "OCC"),⁵ and the US Commodity and Futures Trading Commission,⁶ (the "CFTC") testified before the US Senate Committee on Banking, Housing and Urban Affairs (the "Senate Banking Committee") on "International Harmonization of Wall Street Reform: Orderly Liquidation, Derivatives, and the Volcker Rule." The consensus of the witnesses, particularly among the representatives of the Federal Reserve, the FDIC and the OCC,⁷ is that progress has been made on harmonization of the Dodd Frank⁸ capital requirements⁹ and the Basel capital requirements,¹⁰ but that there are likely to be some inconsistencies between the US and other countries, in part, due to some of the Dodd Frank capital requirements.

Inconsistencies between the US and Other Countries

For instance, in his written testimony before the Senate Banking Committee, Acting Comptroller Walsh indicated that:

"even when broad consensus on international standards is reached, there will be areas of difference where policy makers in individual countries have chosen to tailor standards to their country and institutions rather than adopt the totality of the international approach. This is the case in the U.S., for example, where the Dodd-Frank Act has established certain standards – such as the prohibition on the use of credit ratings in our regulations – that will cause our implementation of the international capital standards to differ in some aspects from those of other countries."¹¹

"While there are many common elements between Basel III and the capital provisions of the Dodd-Frank Act, the Dodd-Frank Act introduces several capital related provisions unique to U.S. financial institutions and, therefore, the U.S. capital standards necessarily will deviate from the international standards in several significant respects."¹²

For a comprehensive discussion of the requirement to remove credit ratings in the context of the capital requirements, see at **"Dodd-Frank Update: Creditworthiness Standards Replace Credit Ratings"** (December 19, 2011).

Specific Changes to the Capital Requirements¹³

The most important changes to the international capital adequacy requirements center on the changes to be made by Basel III, and, for US banks and bank holding companies, the changes to be made by Basel III and Dodd Frank. Some of those changes include a new common equity Tier 1 minimum risk-based capital ratio, narrower definitions that exclude formerly included instruments such as trust preferred securities,¹⁴ narrower definitions that limit the amount of certain types of capital such as mortgage servicing rights and deferred tax assets, increases to the Tier 1 Capital ratio from a minimum of 2% to 4.5%, a new capital conservation buffer of 2.5% common equity Tier 1 Capital and a countercyclical buffer. There are also other requirements, including a new international leverage ratio which is broader than the current US leverage ratio because the new international leverage ratio¹⁵ would include certain off-balance sheet exposures.¹⁶ The new capital requirements for bank holding companies under Dodd Frank Section 171 will also add to the capital requirements. For bank holding companies that are systemically important financial institutions ("SIFIs") that are designated global SIFIs ("G-SIFIs"), there is an additional capital requirement in the nature of a surcharge.¹⁷ For a comprehensive discussion of G-SIFIs and the capital surcharge, see at **"Financial Stability Board Identifies 29 Global SIFIs and Announces Agreed Policy Measures"** (November 7, 2011).

The Basel III Pillars¹⁸

The Basel III requirements are set forth in its three pillars approach, which includes *Capital; Risk Coverage; Containing Leverage; Risk Management and Supervision; Market Discipline; and Liquidity*. The purposes of this approach are to strengthen microprudential regulation and supervision, and add a macroprudential overlay that includes capital buffers:

A. Pillar 1: Capital, Risk Coverage and Containing Leverage

Pillar 1 focuses on the quality and level of capital and makes common equity the key to the quality of the capital. The minimum will be raised to 4.5% of risk-weighted assets, after deductions. Pillar 1 also addresses capital loss absorption at the point of non-viability and requires contractual terms of capital instruments to include a clause that allows, at the discretion of the relevant authority, write-off or conversion to common shares if the bank or bank holding company is judged to be non-viable. This concept is designed to reduce moral hazard. In addition, Pillar 1 has a capital conservation buffer, which consists of common equity of 2.5% of risk-weighted assets, bringing the total common equity standard to 7%. There are also constraints on a bank's or bank holding company's discretionary distributions when a bank or bank holding company falls into the buffer range. Likewise, there is a countercyclical buffer, required within a range of 0-2.5% comprising common equity, when relevant authorities determine that credit growth is resulting in an unacceptable build up of systematic risk. Pillar 1 also expands the risk coverage over securitizations and the trading book. For example, Pillar 1 strengthens the capital treatment for certain complex securitizations and requires banks to conduct more rigorous credit analyses of externally rated securitization exposures. The risk coverage part of Pillar 1 is especially difficult in the US because Dodd Frank does not permit the use of credit ratings. Pillar 1 is also designed to significantly increase capital levels for trading and derivatives activities and complex securitizations held in the trading book. There is also the introduction of a stressed value-at-risk framework to help mitigate procyclicality and a capital charge for incremental risk that estimates the default and migration risks of unsecuritized credit products and takes liquidity into account. The risk coverage expansion of Pillar 1 picks up counterparty credit risk and bank exposure to central counterparties. With respect to counterparty credit risk, there is an enhancement of the counterparty credit risk framework, which includes more stringent requirements for measuring exposure, capital incentives for banks to use central counterparties for derivatives, and higher capital requirements. With respect to bank exposure to central counterparties, the Basel Committee has proposed that trade exposures to a qualifying central counterparty receive a 2% risk weight and default fund exposures to a qualifying central counterparty be capitalized according to a risk-based method that estimates risk arising from the default fund. To contain leverage, there is a non-risk-based leverage ratio that includes off-balance sheet exposures to serve as a backstop to the risk-based capital requirement. This is designed to help contain system wide build up of leverage.

B. Pillar 2: Risk Management and Supervision¹⁹

Pillar 2 addresses enterprise wide governance and risk management and is designed to capture the risk of

off-balance sheet exposures and securitization activities. To achieve this, banks and bank holding companies must manage risk concentrations and provide incentives to better manage risk and returns over the long term. Some of the ways to do this include sound compensation practices, valuation practices, stress testing, accounting standards for financial instruments, corporate governance and supervisory colleges.

C. Pillar 3: Market Discipline²⁰

Market discipline is a key component, especially with respect to securitization exposures and sponsorship of off-balance sheet vehicles. Stronger disclosures promote transparency which is supported by the detail of the components of regulatory capital and their reconciliation to the reported accounts, including a detailed and thorough explanation of how a bank or bank holding company calculates its regulatory capital ratios.

D. Global Liquidity Standard and Supervisory Monitoring²¹

Basel III introduces a global liquidity standard and supervisory monitoring. A liquidity coverage ratio will require banks and bank holding companies to maintain sufficient high-quality liquid assets to withstand a 30-day stressed funding scenario that is specified by supervisors. The net stable funding ratio is a longer-term structural ratio designed to address liquidity mismatches. It covers the entire balance sheet and provides incentives for banks and bank holding companies to use stable sources of funding. The global liquidity standard and supervisory monitoring include principles for sound liquidity risk management and supervision.²²

The Enhanced Prudential Standards

On January 5, 2012, the Federal Reserve published in the Federal Register a proposed rule and request for public comment²³ on Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies (the "Enhanced Prudential Standards"), which are designed to implement the enhanced prudential standards²⁴ requirement of Section 165 of Dodd Frank. While a covered company includes SIFIs, it does not include foreign banking organizations ("FBOs") or the US operations of FBOs that are conducted outside of a US based bank holding company subsidiary. Covered companies would, however, include an FBO's US based bank holding company subsidiary that on its own has total consolidated assets of \$50 billion or more.²⁵ The Enhanced Prudential Standards would impose new capital requirements²⁶ on US bank holding companies as a part of capital plans²⁷ and stress tests.²⁸ The Federal Reserve currently requires a minimum total capital ratio of 8%, a Tier 1 capital ratio of 4% and a Tier 1 leverage ratio of 4%.²⁹ In addition, the Federal Reserve requires a minimum Tier 1 common risk-based capital ratio of 5% over the nine quarters under both the baseline and stress scenarios.³⁰

The New Market Risk-Based Capital Requirements

On December 21, 2011,³¹ the OCC,³² the Federal Reserve and the FDIC published in the Federal Register a notice of proposed rulemaking³³ on Risk-Based Capital³⁴ Guidelines: Market Risk;³⁵ Alternatives to the Credit Ratings for Debt and Securitization Positions (the "Guidelines"),³⁶ which adds new definitions to Section 2 of Appendix B of the risk based capital rules of the Federal Banking Agencies, adds a Schedule A to Section 2, and revises Section 10 of Appendix B. The proposed rulemaking³⁷ would amend a January 11, 2011 notice of proposed rulemaking covering risk capital guidelines,³⁸ in part, by removing the reliance upon credit ratings in accordance with Section 939A of Dodd Frank and replacing them with appropriate alternatives for evaluating creditworthiness. Prior to the January 11 revisions, the capital rules assigned a risk-weighting³⁹ factor based upon the credit rating of a position and whether the credit rating was short term or long term.⁴⁰ The Guidelines propose methodologies for calculating specific risk capital requirements for debt and securitization positions under the market risk capital rules that do not include references to credit ratings.⁴¹ The Guidelines assert that the Federal Banking Agencies have endeavored to calibrate the capital requirements produced under these methodologies to be broadly consistent with the capital requirements under the Basel⁴² standardized measurement for specific risk.⁴³ In general, the Guidelines establish a basis for calculating the "add on" capital to account for market risk in the trading book of certain large banks. Each of the

Federal Banking Agencies has risk-based capital guidelines, typically found in Appendix A, to its risk-based capital regulation. The risk-based capital rules provide that each bank must maintain a minimum ratio of total capital (after deductions) to risk-weighted assets of 8%,⁴⁴ (e.g., Tier 1 Capital plus Tier 2 Capital) and Tier 1 Capital⁴⁵ equal to a minimum Tier 1 leverage ratio of 4%.⁴⁶

The Objectives of the Guidelines

The six objectives that the Federal Banking Agencies attempted to achieve with the Guidelines were to:

1. Appropriately distinguish the credit risk associated with a particular exposure within an asset class;
2. Be sufficiently transparent, unbiased, replicable, and defined to allow banking organizations of varying size and complexity to arrive at the same assessment of creditworthiness for similar exposures and to allow for appropriate supervisory review;
3. Provide for the timely and accurate measurement of negative and positive changes in creditworthiness;
4. Minimize opportunities for regulatory capital arbitrage;
5. Be reasonably simple to implement and not add undue burden on banking organizations; and
6. Foster prudent risk management.⁴⁷

The Federal Banking Agencies also aspire to have "international consistency and competitive equity," which may be a tall order in light of the different economic conditions of banking groups and the global economic crisis.⁴⁸ The market risk-based capital rules⁴⁹ attempt to account for "changes in the market value of a position due to factors other than general market movements."⁵⁰ Banks may use an internal model⁵¹ to measure their exposure to specific risk upon the approval of their prudential supervisor. Otherwise, banks must use the standardized method.⁵² The Guidelines cover positions for *Sovereign Debt; Multilateral Development Banks; Government Sponsored Enterprises; Depository Institutions, Foreign Banks and Credit Unions; Public Sector Entities; Corporate Debt; and Securitizations*.⁵³

A. Exposure Positions to Sovereign Debt⁵⁴

Under current law, sovereign debt for Organization for Economic Cooperation and Development ("OECD") members receives a 0% risk-weighting factor while a non-OECD member receives an 8% risk-weighting factor.⁵⁵ This provides a clear advantage to sovereign debt of OECD members, and the advantage is not necessarily because of the creditworthiness of the OECD member.⁵⁶ The Guidelines would require a banking organization to assign a specific risk-weighting factor to a sovereign debt position based upon the Country Risk Classifications ("CRC")⁵⁷ applicable to the sovereign entity. The Federal Banking Agencies concluded that Section 939A of Dodd Frank was not intended to apply to assessments of creditworthiness of the OECD because, unlike Nationally Recognized Statistical Rating Organizations, "the OECD is not subject to the types of conflicts of interest that Dodd Frank attempted to resolve since the OECD is not a commercial entity that produces credit assessments for fee-paying clients, nor does it provide the sort of evaluative and analytical services as credit rating agencies."⁵⁸ Table 2 of the Guidelines would assign a specific risk-weighting factor ranging from 0.25 to 1.6 for sovereign debt positions.⁵⁹ The CRC also provides a clear advantage to rich countries even though the Federal Banking Agencies are surely aware that the sovereign debt of Portugal, Ireland, Italy, Greece and Spain would not fare well under an objective creditworthiness standard.⁶⁰ To address this admitted shortcoming in the Guidelines that could lead to a misclassification, a 12% risk-weighting factor would apply to sovereign debt positions where the sovereign has defaulted on any exposure during the previous five years.⁶¹ Table 4 of the Guidelines sets forth the CRC classifications and risk-weighting factors in percentages.⁶² For example, a CRC classification of 0-1 would be the equivalent of a 0% risk weighting factor. For a CRC classification in the 2-3 range, the risk weighting factor would be determined by the residual term to final maturity. If the residual term to final maturity is 6 months or less, then the risk weighting factor would be 0.25%; if the residual term to final maturity is greater than 6 months and up to and including 24 months, then the risk weighting factor would be 1.0%; and if the residual term to final maturity is greater than 24 months, then the risk weighting factor would be 1.6%. For a CRC classification in the 4-6 range, the risk weighting factor would be 8%. For a CRC classification of 7, the risk weighting factor would be 12% and where there is no CRC classification, the risk weighting

factor would be 8%.⁶³ The Federal Banking Agencies also considered, as a replacement for credit ratings, credit default swaps spreads or bond spreads.

B. Exposure Positions to Multilateral Development

Banks Under current law, debt positions that are exposures to certain supranational entities and multilateral development banks ("Multilateral Development Banks")⁶⁴ receive risk-weighting factors ranging from 0.25% to 1.6%, depending upon the remaining maturity. However, the Guidelines would assign a 0% risk-weighting factor to debt positions that are exposures to the Bank for International Settlements, the European Central Bank, the European Commission, and the International Monetary Fund. The Guidelines would also assign a 0% risk-weighting factor to debt positions that are exposures to Multilateral Development Banks. The basis for better treatment of Multilateral Development Banks under the Guidelines is the belief of the Federal Banking Agencies that Multilateral Development Banks generally have high credit quality, strong shareholder support, and a shareholder structure comprised of a significant proportion of sovereign entities with strong creditworthiness. The Guidelines indicate that regional development banks and multilateral lending institutions will generally receive the same treatment as corporate debt positions.

C. Exposure Positions to Government Sponsored Enterprises⁶⁵

Under the current law, debt positions that are exposures to public sector entities such as government sponsored enterprises⁶⁶ are assigned risk-weighting factors ranging from 0.25% to 1.6%, depending on maturity.⁶⁷ Freddie Mac, Fannie Mae, the Farm Credit System, and the Federal Home Loan Bank System are expressly identified as government sponsored enterprises. Though Freddie Mac and Fannie Mae are currently in conservatorship, they would still receive favorable treatment under the Guidelines. The Guidelines would assign risk-weighting factors ranging from 0.25% to 1.6% to debt positions based upon the remaining maturity of the positions. Equity exposures, including preferred stock, however, would be assigned a risk-weighting factor of 8%.

D. Exposure Positions to Depository Institutions, Foreign Banks and Credit Unions

Under the current law, debt positions that are exposures to a depository institution, foreign bank or credit union licensed or chartered by OECD countries generally are assigned a risk-weighting factor ranging from 0.25% to 1.6% based upon the remaining maturity of the position. Other depository institutions, foreign banks or credit unions, however, are only assigned a risk-based weighting factor in the same range if the debt has an investment-grade rating from a credit rating agency or assessments of comparable credit quality by the investing bank. Otherwise, banks licensed or chartered in a non-OECD member country will have a higher risk-weighting factor. The Guidelines would not favor banks licensed or chartered in an OECD member country. Table 3 of the Guidelines would assign a specific risk-weighting factor ranging from 0.25 to 1.6 for depository institutions, foreign banks and credit union debt positions.⁶⁸ The Guidelines would apply risk-weighting factors to debt positions that are exposures to depository institutions,⁶⁹ such as FDIC-insured banks and thrifts, foreign banks,⁷⁰ US branches and agencies of international banks, and FDIC-insured credit unions,⁷¹ based upon the CRC of the country of the head office. For instance, Table 6⁷² of the Guidelines shows that the risk-weighting factor for a depository institution, foreign bank or credit union where the CRC of the country of the head office ranged between 0-2 with a residual term to final maturity of 6 months or less would be 0.25%; the risk-weighting factor for a depository institution, foreign bank or credit union where the CRC of the country of the head office ranged between 0-2 with a residual term to final maturity of up to and including 24 months would be 1.0%; the risk-weighting factor for a depository institution, foreign bank or credit union where the CRC of the country of the head office ranged between 0-2 with a residual term to final maturity exceeding 24 months would be 1.6%; the risk-weighting factor for a depository institution, foreign bank or credit union where the CRC of the country of the head office was 3 would be 8.0%; the risk-weighting factor for a depository institution, foreign bank or credit union where the CRC of the country of the head office ranged between 4-7 would be 12.0%; and the risk-weighting factor for a depository institution, foreign bank or credit union where there was no CRC of the country of the head office would be 8.0%. When the depository institution, foreign bank or credit union is assigned an 8.0%

risk-weighting factor because of a lack of CRC rating, then the debt position that is an exposure to that entity would also be assigned an 8% risk-weighting factor.

E. Exposure Positions to Public Sector Entities

Under the current law, risk-weighting factors for general obligations of states and other political subdivisions⁷³ of OECD member countries range from 0.25% to 1.6% based upon maturity. Exposure positions that are revenue obligations of states and other political subdivisions of OECD member countries are treated in the same manner if the debt is rated investment grade or is assessed as comparable credit quality to investment grade. The Guidelines would create and define the term Public Sector Entity⁷⁴ as a state, local authority, or other governmental subdivision below the level of a sovereign entity. An exposure to a Public Sector Entity would be assigned a risk-weighting factor based upon the CRC assigned to the country where the Public Sector Entity was incorporated and whether the position is a general obligation⁷⁵ or a revenue obligation⁷⁶ of the Public Sector Entity. Table 4 and Table 5 of the Guidelines would assign a specific risk-weighting factor ranging from 0.25 to 1.6 for Public Sector Entity debt positions.⁷⁷

F. Exposure Positions to Corporate Entities

Under current law, the risk-weighting factors for debt and securitization positions are based on the Basel Committee's 1996 market risk framework. This means the risk-weighting factor is determined by the type of obligor, the credit rating of the obligor, and the remaining maturity of the exposure. The Guidelines would permit a bank to use a methodology based upon market-based information and historical accounting information (indicator-based methodology)⁷⁸ to assign specific risk-weighting factors to corporate debt positions⁷⁹ that are exposures to a publicly-traded entity that is not a financial institution,⁸⁰ and to assign a risk-weighting factor of 8.0% to all other corporate debt positions excluding those that are exposures to a depository institution, foreign bank, or credit union. To use this methodology, a bank must calculate the leverage (measured by the ratio of total liabilities to the market value of assets ("Debt")); the cash flow (measured as the ratio of earnings before interest expense, taxes, depreciation and amortization to a market value of assets ("EBITDA")); and monthly stock return volatility ("Volatility").⁸¹ After making these calculations, the bank would assign the debt position that is an exposure to a publicly traded, non-financial institution consistent with Table 11 of the Guidelines.⁸² In Table 11, where an EBITDA to asset ratio is greater than zero, and the stock return volatility measure is less than 0.1, then the risk-weighting factor would be 1% where the Debt to assets ratio is less than 1%, 8.0% when the Debt to assets ratio is between 0.2% and 0.5% and 8% when the Debt to assets ratio is greater than 0.5%. Likewise, the risk-weighting factor is 8% in all other cases, except the risk-weighting factor is 12% when the stock return volatility measure is greater than 0.15. Alternatively,⁸³ a bank may assign an 8.0% risk-weighting factor to all of its corporate debt positions. Table 9 of the Guidelines shows the risk-weighting factors for corporate debt positions. Table 9 makes a distinction between Qualifying⁸⁴ corporate debt and Other⁸⁵ corporate debt. In general, companies are assigned a 100% risk-weighting factor. However, the risk-weighting factor is more favorable, for example, if the debt is guaranteed or the security is issued by an OECD member country and certain safety and soundness conditions are met. Table 6A of the Guidelines would assign a specific risk-weighting factor ranging from 0.25 to 1.6 for certain non-financial publicly-traded company debt positions.⁸⁶ However, Table 6 of the Guidelines would assign a specific risk-weighting factor ranging from 8%⁸⁷ to 12% for non-financial publicly-traded company debt positions.⁸⁸

G. Exposure Positions to Securitizations⁸⁹

Under current law, if a bank does not model specific risk, it must calculate a specific risk capital add-on for each securitization position⁹⁰ subject to the rule using a standardized method, where a bank must multiply the absolute value of the current market value of each net long and net short position in a securitization⁹¹ position by the appropriate specific risk-weighting factor ranging from 0% to 8% based upon the credit rating and the remaining contractual maturity of the position.⁹² The bank would also have to apply the highest specific risk-weighting factors based on the credit ratings shown in Table 13 and Table 14 of the Guidelines.⁹³ Under the Guidelines, a banking organization may assign a specific risk-weighting factor to a securitization position using the simplified supervisory

formula approach. A banking organization that does not use the simplified supervisory formula approach for a securitization position must assign a specific risk-weighting factor of 100% to the position.⁹⁴ A banking organization must assign a minimum specific risk-weighting factor to a securitization position based upon the cumulative losses as a percent of the original dollar value of KG in accordance with Table 7 of the Guidelines.⁹⁵ Table 7 of the Guidelines would assign a specific risk-weighting factor ranging from 1.6% to 100% to a securitization position.

Table 13 shows how long-term credit rating specific risk-weighting factors impact securitization positions and re-securitization⁹⁶ positions in the Basel market risk framework. For example, an AAA rating and an AA rating would translate into a 1.60% specific risk-weighting factor for a securitization that is not a re-securitization; a re-securitization with an AAA rating and an AA rating would translate into a 3.20% specific risk-weighting factor. Likewise, an A rating would translate into a 4% specific risk-weighting factor for a securitization that is not a re-securitization and a re-securitization with an A rating would translate into an 8% specific risk-weighting factor. A BBB rating would translate into an 8% specific risk-weighting factor for a securitization that is not a re-securitization and a re-securitization with a BBB rating would translate into an 18% specific risk-weighting factor. A BB rating would translate into a 28% specific risk-weighting factor for a securitization that is not a re-securitization and a re-securitization with a BB rating would translate into a 52% specific risk-weighting factor. A B rating and a CCC rating would translate into a 100% specific risk-weighting factor for a securitization and for a re-securitization.

Table 14 shows how short-term credit rating specific risk-weighting factors impact securitization positions and re-securitization positions in the Basel market risk framework. For instance, an A-1/P-1 rating would translate into a 1.60% specific risk-weighting factor for a securitization that is not a re-securitization and a re-securitization with an A-1/P-1 rating would translate into a 3.20% specific risk-weighting factor. Similarly, an A-2/P-2 rating would translate into a 4% specific risk-weighting factor for a securitization that is not a re-securitization and a re-securitization with an A-2/P-2 rating would translate into an 8% specific risk-weighting factor. An A-3/P-3 rating would translate into an 8% specific risk-weighting factor for a securitization that is not a re-securitization and a re-securitization with an A-3/P-3 rating would translate into an 18% specific risk-weighting factor. All other such short term ratings would receive a 100% specific risk-weighting factor.

The Guidelines change the methodology for securitizations and re-securitizations by using "a simplified version of the Basel II advanced approaches supervisory formula approach" ("SFA")⁹⁷ to assign specific risk-weighting factors to securitization positions and re-securitization positions.⁹⁸ If a bank can not or does not use the simplified SFA,⁹⁹ a securitization position would be subject to a specific risk-weighting factor of 100%, which is roughly the equivalent of a 1,250% risk weight. To calculate the simplified SFA,¹⁰⁰ a bank would need the weighted-average capital requirement under the general risk-based capital rules that would be assigned to the underlying exposures, if those exposures were held directly by the bank, the position's level of subordination and relative size within the securitization, and the level of losses actually experienced on the underlying exposures.

Table 15¹⁰¹ sets forth the supervisory minimum specific risk-weighting factor floors for securitization exposures for cumulative losses of principal on originally issued securities as a percentage of the weighted-average capital requirement of the underlying exposures calculated using the general risk-based capital rules of the Federal Banking Agencies at origination. Under Table 15, if the cumulative losses of principal are greater than 0, but less than or equal to 50, then the specific risk-weighting factor will be 1.6%. Likewise, if the cumulative losses of principal are greater than 50, but less than or equal to 100, then the specific risk-weighting factor will be 8%. In addition, if the cumulative losses of principal are greater than 100, but less than or equal to 150, then the specific risk-weighting factor will be 52% and if the cumulative losses of principal are greater than 150, then the specific risk-weighting factor will be 100%. Table 16 provides an example of a hypothetical residential mortgage-backed securitization to help illustrate how the Guidelines would work in practice. Under Table 16, S means a senior most tranche, and M1, M2 and M3 are the three junior tranches.

Table 16¹⁰² shows that Tranche S has a current balance of \$1,988,831,790, its attachment point is 10%, its detachment point is 100%, and its simplified SSF specific risk-weighting factor is 1.6%. In addition, Tranche M1 has a

current balance of \$88,392,524, its attachment point is 6%, its detachment point is 10%, and its simplified SSF specific risk-weighting factor is 15.9%. Tranche M2 has a current balance of \$44,196,262, its attachment point is 4%, its detachment point is 6%, and its simplified SSF specific risk-weighting factor is 63.2% and Tranche M3 has a current balance of \$88,392,524, its attachment point is 0%, its detachment point is 4%, and its simplified SSF specific risk-weighting factor is 100%. Table 16 assumes that cumulative losses are equal to \$121,539,720 (or 5.50% of the original balance) and this represents losses that are approximately 137% of the original amount of capital that would be required to be held against the underlying exposures at origination as if they were held directly by a bank. The simplified SSF specific risk-weighting factor for the S Tranche increases from 1.6% to 52%. This means the simplified SSF specific risk-weighting factor for the M1 Tranche increases from 15.9% to 97%, the simplified SSF specific risk-weighting factor for the M2 Tranche increases from 63.2% to 100%. The M3 Tranche is reduced to zero dollars because it now absorbs losses in the amount of its principal balance and the Tranche M2 is reduced in dollar amount from \$44,196,262 to \$11,049,066 because it absorbs the losses not absorbed by M3.

H. Capital Treatment between Modeled and Non-Modeled Securitization Positions

The Guidelines provide different treatment for modeled and non-modeled securitization positions. For instance, on the one hand, for purposes of a bank calculating its comprehensive risk measure with respect to either the surcharge or floor calculation for a portfolio of correlation trading positions modeled under the Guidelines, the total specific risk add-on would be the greater of the sum of the bank's specific risk add-ons for each net long correlation trading position calculated using the standardized measurement method or the sum of the bank's specific risk add-ons for each net short correlation trading position calculated using the standardized measurement method. On the other hand, for a bank's securitization positions that are not correlation trading positions and for securitization positions that are correlation trading positions not modeled under the Guidelines, then, the total specific risk add-on would be the greater of the sum of the bank's specific risk add-ons for each net long securitization position calculated using the standardized measurement method or the sum of the bank's specific risk add-ons for each net short securitization position calculated using the standardized measurement method.

SNR Denton Observations

The financial crisis has had negative repercussions across the globe, and many countries and their financial systems, including the richest countries in the world, have not fully recovered. Among the most devastating impacts of the crisis has been the demise of small financial institutions, including hundreds of community bank failures in the US. The consensus among US policymakers is that US banking groups and banking groups operating in the US would benefit from enhanced capital requirements, and enhanced capital requirements would make the US financial system more resilient and more capable of enduring another financial crisis. Prudential supervisors also believe that enhanced capital requirements are necessary to reduce the risk of a banking crisis and to help banks better manage a banking crisis. Both US policymakers and prudential supervisor agree that the challenge for the US is to develop enhanced rules without putting US banking groups at a competitive disadvantage.

First, the current version of Basel III places more reliance on common equity capital ratios than Basel II reflecting the view that common equity is the best loss absorbing capital and that some capital is qualitatively better than other capital. As the result, Basel III would make certain current Tier 1 and Tier II capital ineligible over time to be counted as regulatory capital. For example, deferred tax assets, mortgage servicing rights, and investments in common shares of unconsolidated financial institutions would be eliminated, and certain hybrid securities such as trust preferred securities would be disfavored. These changes will very likely mean that the cost of capital for banking groups, especially community banks, will increase.

Second, it is too early to know whether international supervisors and the Basel Committee can level the playing field and prevent one or more countries from having a competitive advantage over certain other countries. The Basel Committee essentially makes recommendations that each country is free to adopt or not adopt. While the Basel capital requirements are intended to assure international consistency, different countries have adopted different versions of the Basel capital requirements and, thus, different Basel requirements apply to different financial

institutions. For example, some countries currently operate under Basel I while other countries operate under Basel II. Still other countries operate under Basel II.5 and no major country currently operates under Basel III. Likewise, in the US, for instance, many community banks operate under Basel I while many of the largest banks operate under Basel II and Basel II.5.

Third, Dodd-Frank's capital rules will necessarily be consistent with some of the Basel capital requirements and inconsistent with other Basel capital requirements. Many of the Dodd Frank capital rules are directed towards large banking groups and Dodd Frank does not take into account that there is no one set of Basel capital requirements actually implemented in all countries. For instance, Basel I was adopted by the Basel Committee in 1988 and implemented in 1992. Basel I was amended by the Basel Committee in 1996 to take into account market risk. Basel II was adopted by the Basel Committee in 2004 and implemented in 2011. Basel II.5, which updates the market risk requirements, was adopted by the Basel Committee in 2009 and implemented in 2011. Basel III was adopted by the G-20 countries in 2010, but will commence its phased implementation commencing in 2013 and continuing to 2019. Equally importantly, the US and certain parts of Western Europe have been extremely aggressive with capital requirements, but not even the Western European countries have anything like the requirements Dodd Frank has imposed on the largest banking groups in the US such as a Collins Amendment, the Federal Reserve's enhanced prudential standards or the removal of credit ratings from the federal banking regulations. In addition, those banking groups that have been designated a G-SIFI will need an additional capital buffer, which will make capital more expensive for banking groups headquartered in certain countries and certain banking groups within the same countries. This uneven treatment of large banking groups within the same country may change the competitive landscape within certain countries.

Fourth, a bank's trading book is likely to be more affected than its banking book because general market risk factors affect the value of all positions in a bank's trading account that are driven by changes in interest rates, foreign exchange rates, or equity and commodity prices. General market risks arise from changes in the level of interest rates on Treasury securities, from changes in the credit spreads for all borrowers of similar credit quality, and from changes in foreign exchange rates.

Fifth, the cost of capital and the risk-based capital charge will also be influenced by accounting issues, and guidance on accounting rules has not kept pace with the avalanche of guidance and regulations on the risk based capital treatment. Despite years of promises from accounting organizations and various US and international regulators, we have yet to see a convergence between US accounting standards under Generally Accepted Accounting Principles and international accounting standards under the International Financial Reporting Standards.

Sixth, the combined capital rules could mean that investors will find some bank holding company stocks less attractive because some bank holding companies will not have enough capital under the Federal Reserve's required capital plan and stress test to be permitted by the Federal Reserve to make distributions to investors. This could have the unintended consequence of further weakening the bank holding company as a source of strength for the bank or banks it owns or controls.

Seventh, the combined capital rules may increase the pressure on bank holding companies to sell assets that they would otherwise not sell and to rethink growth that may be in the best interest of the bank holding company. In many cases, growth may be necessary for the bank holding company to compete or maintain its market share. In other cases, growth may be necessary for the bank holding company to maintain its customer base. Yet banks and bank holding companies may find asset sales to be the easiest way to meet the capital requirements of their supervisors.

Eighth, the Collins Amendment could be a disincentive for large banks and large bank holding companies to invest in internal models that better capture risk, thus having the unintended consequence of weakening the risk management system of the bank or bank holding company. This weakened risk management system could form one of the bases for a bank taking on more risk than it otherwise would have had the bank invested in an internal model.

¹ The Honorable Lael Brainard, Under Secretary for International Affairs.

² The Honorable Daniel K. Tarullo, Federal Reserve Governor.

- 3 The Honorable Elisse B. Walter, Commissioner.
- 4 The Honorable Martin J. Gruenberg, Acting Chairman.
- 5 The Honorable John Walsh, Acting Comptroller of the Currency.
- 6 The Honorable Director, Jacqueline H. Mesa, Office of International Affairs, CFTC.
- 7 Collectively, the Federal Reserve, the FDIC and the OCC are referred to as the Federal Banking Agencies.
- 8 Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank").

Title I of Dodd Frank sets forth many of the capital requirements, including Section 115 (b) (prudential standards), Section 115 (c) (contingent capital), Section 165 (b) (prudential standards for nonbank financial companies), Section 165 (c) (contingent capital for nonbank financial companies), Section 165 (i) (stress tests), Section 165 (k) (inclusion of off-balance sheet activities in computing capital requirements), and Section 171 (b) (minimum capital requirements).

Acting Comptroller Walsh defined the Basel capital requirements as (A) the minimum risk based capital requirements for US banking organizations based upon the "International Convergence of Capital Measurement and Capital Standards" (July 1988) ("Basel I"); (B) the advanced approaches risk based capital rules for the largest internationally active banks on a new international capital adequacy framework set forth in the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (June 2006) ("Basel II"); (C) the revisions to the market risk framework and the treatment of certain securitization exposures set forth in "Revisions to the Basel II Market Risk Framework, Guidelines for Computing Capital for Incremental Risk in the Trading Book, and Enhancements to the Basel II Framework" and "Changes to the Revisions to the Basel II market risk framework" at **Changes to the Revisions to the Basel II market risk framework** (Basel II.5"); and (D) the new capital standards in response to the financial crisis set forth in the "Bank for International Settlements, Basel Committee on Banking Supervision, Basel III: A global regulatory framework for more resilient banks and banking systems" (December 2010, revised June 2011) ("Basel III"). For a list of events that puts the financial crisis in context, see "The Financial Crisis: A Timeline of Events and Policy Actions" published by the Federal Reserve Bank of St. Louis at **The Financial Crisis**. In December 2010, the Basel Committee on Bank Supervision (the "Basel Committee") approved the Basel III framework, which is scheduled to be implemented from January 1, 2013, if appropriate regulatory bodies and national governments move forward. According to the Basel Committee's "Progress report on Basel III Implementation (October 2011)," as of the end of September 2011, the overwhelming majority of countries, including the US and the EU had adopted a final rule on Basel II (although in the US some institutions are continuing to work towards implementing the Basel II advanced approaches). This means that most of the countries currently operate under the Basel II framework.

11 See Testimony of John Walsh, Acting Comptroller of the Currency before the Committee on Banking, Housing, and Urban Affairs United States Senate (March 22, 2012) at page 3.

See Testimony of John Walsh, Acting Comptroller of the Currency before the Committee on Banking, Housing, and Urban Affairs United States Senate (March 22, 2012) at pages 8-9. In support of his position, Acting Comptroller Walsh cited language in Section 171 of Dodd Frank (the "Collins Amendment") and explained that under the Collins Amendment "any regulatory capital requirement that the federal banking agencies apply to any subset of banks (such as the advanced approaches rules, which are required only for large internationally active banks) is permitted to increase the capital requirements relative to the generally applicable minimum capital requirements, but is not permitted to decrease them.

12 Additionally, the Collins Amendment requires that the generally applicable minimum capital requirements may never be "quantitatively lower" than the current Basel I-based minimum capital requirements....And a foreign bank pursuing the same strategy and operating with the floor would enjoy a market advantage over their U.S. counterparts." See Walsh testimony at 9. Walsh also cites Section 939A of Dodd Frank, which requires all federal agencies to remove reference to and reliance upon credit ratings. Likewise, Acting Comptroller Walsh essentially asserts that there will be differences in Basel III among different countries based upon how the law is implemented. In support of his assertion, he cites the differences in how the law was implemented under the advanced approaches.

In remarks on November 9, 2011, Federal Reserve Governor Daniel K. Tarullo asserted that the financial crisis showed that concentrated, almost all-consuming regulatory focus on refining bank capital requirements in Basel II had come at the expense of attention to other risks in the financial system. In particular, he argued the banking regulators failed to appreciate fully the implications of the growth--in size, leverage, and maturity transformation levels--of the shadow banking system for the balance sheets of commercial banks and for overall financial stability. The crisis, he argued, showed that liquidity problems can be an independent source of severe stress, perhaps even for firms that might otherwise have remained solvent, but it was also evident that the specifics of pre-crisis capital regulation fell far short of what this prudential instrument can achieve. See "The Evolution of Capital Regulation," by Federal Reserve Governor Daniel K. Tarullo on November 9, 2011 at the Clearing House Business Meeting and Conference, New York, New York.

14 Federal Reserve Governor Tarullo also pointed out that "at least some of the instruments that qualified as "Tier 1 capital" for regulatory purposes were not reliable buffers against losses, at least not on a going concern basis. It is instructive that during the height of the crisis, counterparties and other market actors looked almost exclusively to the amount of tangible common equity held by financial institutions in evaluating the creditworthiness and overall stability of those institutions. They essentially ignored the Tier 1 and total risk-based capital ratios in regulatory requirements. In the fall of 2008, there was widespread doubt in markets that the common equity of some of our largest institutions was sufficient to withstand the losses that those firms appeared to be facing. This doubt made investors and counterparties increasingly reluctant to deal with those firms, contributing to the severe liquidity strains that characterized financial markets at the time." See "The Evolution of Capital Regulation," by

Federal Reserve Governor Daniel K. Tarullo on November 9, 2011 at the Clearing House Business Meeting and Conference, New York, New York. According to Acting Comptroller Walsh, Basel III's liquidity coverage ratio has a one month time horizon and is intended to address short-term resilience by ensuring that a bank has sufficient high quality liquid resources to offset cash outflows under acute short-term stresses, but Basel III's net stable funding ratio is targeted toward promoting longer term resilience by creating additional incentives for a bank to fund its ongoing activities with stable sources of funding. See Walsh testimony at pages 11-12.

See also Dodd Frank Section 165 (j) (leverage limitations).

To date, only globally systemically important banking groups have been designated G-SIFIs. See "Basel Committee on Banking Supervision reforms - Basel III" at [Basel Committee on Banking Supervision reforms - Basel III](#); See also "Basel III: A global regulatory framework for more resilient banks and banking systems December 2010 (rev June 2011)" at [Basel III: A global regulatory framework for more resilient banks and banking systems](#).

See "Basel Committee on Banking Supervision reforms - Basel III" at [Basel Committee on Banking Supervision reforms - Basel III](#).

See "Basel Committee on Banking Supervision reforms - Basel III" at www.bis.org/bcbs/basel3/b3summarytable.pdf. See also Basel Committee on Banking Supervision Pillar 3 disclosure requirements for remuneration (July 2011) at [Pillar 3 disclosure requirements for remuneration](#).

The Basel Committee's 2008 guidance "Principles for Sound Liquidity Risk Management and Supervision" takes account of lessons learned during the crisis and is based on a fundamental review of sound practices for managing liquidity risk in banking organizations. The liquidity framework includes a common set of monitoring metrics to assist supervisors in identifying and analyzing liquidity risk trends at the bank level, the holding company level and the system-wide level.

See also Office of Financial Research Working Paper #0002 (March 26, 2012) "Forging Best Practices in Risk Management".

See 77 F.R. 594 (January 5, 2012), which would become 12 C.F.R. 252, if it becomes a final rule. The initial comment period, which was set to expire on March 31, 2012, was extended to April 30, 2012.

While the enhanced prudential standards requirement covers risk-based capital and leverage requirements, liquidity standards, requirements for overall risk management, single counterparty credit limits, stress test requirements, and a debt to equity limit, the focus of this alert is the risk-based capital requirement. Other such enhanced prudential standards are beyond the scope of this alert and may only receive a cursory discussion. While much of the focus of the capital requirements falls on banks, the Enhanced Prudential Standards are focused on "stronger regulation of major bank holding companies and nonbank financial companies" designated by the Financial Stability Oversight Council (the "FSOC") pursuant to Section 113 of Dodd Frank for supervision by the Federal Reserve.

With the exception of the proposed liquidity and enterprise wide risk management requirements and any debt to equity limit that the FSOC has determined to pose a grave threat to US financial stability, the Enhanced Prudential Standards would not apply to any bank holding company subsidiary of an FBO that has relied upon Federal Reserve Supervision and Regulation Letter SR 01-01(as in effect on May 19, 2010) until July 21, 2015.

12 C.F.R. 225.13 (a) provides that a covered company that is a bank holding company must comply with and hold capital commensurate with the requirements of any regulations adopted by the Federal Reserve relating to capital plans and stress tests.

See 76 F.R. 74631 (December 1, 2011) and 12 C.F.R. 225.8. US bank holding company SIFIs must submit capital plans to the Federal Reserve.

The capital plan rule requires bank holding companies to demonstrate capital adequacy over a minimum of nine quarters under both expected and stress conditions.

On March 13, 2012, the Federal Reserve released the results of the most recent stress tests. The Federal Reserve in the Comprehensive Capital Analysis and Review evaluates the capital planning processes and capital adequacy of the largest bank holding companies. The stress scenario included a peak unemployment rate of 13%, a 50% drop in equity prices, and a 21% decline in housing prices. Under this scenario, the aggregate Tier 1 common capital ratio, which compares high-quality capital to risk-weighted assets, fell from 10.1% in the third quarter of 2011 to 6.3% in the fourth quarter of 2013. Fifteen of the 19 bank holding companies were estimated to maintain capital ratios above all four of the regulatory minimum levels under the hypothetical stress scenario, even after considering their proposed capital actions such as dividend increases or share buybacks. "Basel I and Basel II capital requirements relied almost exclusively on capital ratios that were essentially snapshots of balance sheets and thus all too often a lagging indicator of a bank's condition. Declines in asset values--particularly of non-traded assets--were often not reflected in capital calculations for some time. Though already well-known before the crisis, this phenomenon was particularly problematic as asset values declined rapidly, causing both markets and supervisors alike to regard regulatory capital ratios as providing only limited information about a firm's current financial condition...The crisis validated the concerns expressed by some academics and by policy staff at the Bank for International Settlements that the effectiveness of capital regulation was limited by its exclusively microprudential focus. Capital requirements had been set with reference solely to the balance sheet of a specific firm. The risk weights assigned to the firm's assets were calculated with reference to ordinary times, whether through a supervisory determination or a combination of supervisory formulas and a firm's own modeling. This microprudential focus did not take into account the potential impact of a shock to the value of widely-held assets--whether exogenous, caused by the distress sales of such assets by a large firm suffering particularly severe problems, or, as in the financial crisis, a lethal interaction between these two factors." See "The Evolution of Capital Regulation," by Federal Reserve Governor Daniel K. Tarullo on November 9, 2011 at the Clearing House Business Meeting and Conference, New York, New York.

29 12 C.F.R. 252.13 (b)(2) provides that a nonbank covered company must hold capital sufficient to meet a tier 1 risk based capital ratio of 4% and a total risk based capital ratio of 8% and a tier 1 leverage ratio of 4%.

30 Bank holding companies that fail to meet the requirements of the Federal Reserve are precluded from making capital distributions until the Federal Reserve's requirements are met.

31 The comment period closed on February 3, 2012.

The OCC's Risk-Based Capital Guidelines; Market Risk Adjustment is set forth at 12 C.F.R. 3, Appendix B ("Appendix B"). Appendix B applies to national banks and Federal branches whose trading activity (on a worldwide consolidated basis) equals 10% or more of total assets or \$1 billion or more. The OCC has the discretion to include or exclude any national bank or Federal branch based upon accounting, operational and safety and soundness issues. Trading activity means the gross sum of trading assets and liabilities as reported in the bank's most recent quarterly

32 Consolidated Report of Condition and Income ("Call Report"). Total assets means quarter-end total assets as reported in the bank's most recent Call Report. See Section 1 and Section 2, Appendix B. The Federal Reserve and the FDIC have regulations with the same applicability requirements for banks they supervise. See Federal Reserve Trading and Capital-Markets Activities Manual ("Trading Activities Manual") at Section 2110.1.

33 76 F.R. 79380 (December 21, 2011).

For risk-based capital purposes, capital includes a core capital element (commonly known as Tier 1 Capital) and supplemental capital elements (commonly known as Tier 2 Capital). Core capital includes common equity, including capital stock, surplus and undivided profits; qualifying

34 noncumulative perpetual preferred stock (for bank holding companies, cumulative perpetual preferred stock so long as the aggregate does not exceed 25% of Tier 1 Capital); and minority interests in the equity accounts of consolidated subsidiaries. Supplemental capital includes a limited amount of the allowance for loan and lease losses, certain perpetual preferred stock, mandatory convertible securities, certain term subordinated debt and certain other assets. See Trading Activities Manual at Section 2110.1.

Market risk means the risk of loss resulting from movements in market prices. Market risk consists of general market risk and specific risk components. General market risk means changes in the market value of covered positions resulting from broad market movements, such as

35 changes in the general level of interest rates, equity prices, foreign exchange rates or commodity prices. Specific risk means changes in the market value of specific positions due to factors other than broad market movements and includes default and event risk as well as idiosyncratic variations. See Section 2, Appendix B; Trading Activities Manual at Section 1000.1.

The OCC's capital regulation is set forth at 12 C.F.R. 3. The Federal Reserve's capital regulations are set forth at 12 C.F.R. 208 and 12 C.F.R. 225.

36 The FDIC's capital regulation is set forth at 12 C.F.R. 325. The market risk capital rules of the Federal Reserve are set forth in Appendix E, Section 5. The market risk capital rules of the FDIC are set forth in Appendix C, Section 5.

The Guidelines modify the market risk capital rules published in the Federal Register on January 11, 2011 because the January 11 market risk

37 capital rules did not include the methodologies adopted by the Basel Committee for calculating the risk capital requirements for certain debt and securitization positions.

The January 11 revisions were made "to better capture those positions for which application of the market risk capital rules are appropriate, address shortcomings in the modeling of certain risks, address procyclicality concerns, enhance the rules' sensitivity to risks that are not adequately captured under the current regulatory capital measurement methodologies, and increase transparency through enhanced disclosures." The January 11 notice of proposed rulemaking was based upon the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," and revisions included in "The Application of Basel II to Trading Activities" and the "Treatment of Double Default Effects," at

38 **International Convergence of Capital Measurement and Capital Standards** published jointly by the International Organization of Securities Commissions and the Basel Committee in 2005 (2005 revisions), and revisions developed by the Basel Committee and published in three documents in July 2009: "Revisions to the Basel II Market Risk Framework," "Guidelines for Computing Capital for Incremental Risk in the Trading Book," and "Enhancements to the Basel II Framework". The problem with these publications is that they relied upon credit ratings. *Id.* Under Basel II, banks have explicit capital charges against market risk, operational risk and credit risk and may be subject to other capital charges at the discretion of the prudential supervisor. Basel I had a market risk capital charge and a credit risk capital charge, but not an operational risk capital charge.

Each asset and off-balance sheet item is assigned to one of four broad risk categories based upon the obligor or, if relevant, the guarantor or type of collateral. The risk categories are 0%; 20%; 50%; and 100%. The standard risk category for most items is 100%. The appropriate dollar value of the amount in each category is multiplied by the risk weight associated with that category. The weighted values are added together and the

39 resulting sum is the risk-weighted assets, the denominator of the risk-based capital ratio. The numerator of an institution's risk-based capital ratio consists of a combination of core capital, supplemental capital, and Tier 3 Capital, which may only be used to meet market risk capital requirements. See Trading Activities Manual at Section 2110.1.

The Guidelines explain that for the market risk capital rules, the specific risk-weighting factor is a scaled measure that is similar to the "risk weights" used in the general risk-based capital regulations (i.e., 0%; 20%; 50%; and 100% risk weights) for determining risk-weighted assets. The measure

40 for market risk proposed under the January 2011 notice of proposed rulemaking is multiplied by 12.5 to convert it to market risk equivalent assets, which are then added to the denominator of the risk-based capital ratio.

- 41 Table 1 of the Guidelines show that credit ratings are used for sovereign debt positions, multilateral development bank positions, public sector entity positions, bank positions, corporate debt positions, and securitizations.
- In July 1988, the central bank governors of the Group of Ten countries adopted the Basel Capital Accord "International Convergence of Capital Measurement". The document was developed by supervisors on the Basel Supervisors Committee, consisting of representatives from Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, the United Kingdom and the US. The first Basel consultative document was "A New Capital Adequacy Framework" and was issued on June 3, 1999. The second Basel Committee consultative document was "The New Basel Capital Accord" and was issued in January 2001. Basel I required assets and off-balance sheet items to be risk weighted based upon credit risk using a 100% risk weight for the riskiest assets or off-balance sheet items, followed by a 50% risk weight, a 20% risk weight and a 0% risk weight for the least risky assets or off-balance sheet items. The idea was to provide an incentive to banks to hold more capital if they choose the riskiest assets, but not to penalize them if they held very safe assets. The primary shortcoming with the Basel I was that it allowed capital arbitrage
- 42 especially for securitizing banks, and bank supervisors wanted to be able to use market discipline and risk metrics used by the banks. The supervisors felt this would allow for a more risk sensitive framework. See "Basel and the Evolution of Capital Regulation: Moving Forward, Looking Back"(January 14, 2003) at www.fdic.gov/bank/analytical/fyi/2003/011403fyi.html. Basel I required internationally active banks to have a minimum total risk-based capital ratio of 8% and Tier 1 risk-based capital ratio of 4%; certain defined capital instruments to constitute the numerator of the capital-to-risk weighted assets ratio; and a system of risk weights for calculating the denominator of the ratio. See "Bank Capital Requirements Potential Effects of New Changes on Foreign Holding Companies and U.S. Banks Abroad" (January 2012) issued by the US Government Accounting Office, GAO-12-235, Page 7. According to the GAO report, Basel I "was not providing a sufficiently accurate measure of capital adequacy because of the lack of risk sensitivity in its credit risk weightings, financial market innovations such as securitization and credit derivatives, and advancements in banks' risk measurement and risk management techniques." *Id.*
- Under the Basel II standardized approach, a standardized set of risk weights is applied to different asset categories. The standardized approach applies more risk buckets than Basel I and relies upon external rating agencies to help determine risk. In contrast, the internal ratings-based
- 43 approach of Basel II allows banks themselves to estimate the amount of capital needed to support their unique set of risks. This approach, however, is limited to those banks, typically the largest banks, which demonstrate the ability to conduct a credit risk analysis that is acceptable to the prudential supervisor. There are two levels of the internal ratings approach (foundation or advanced). See "Basel and the Evolution of Capital Regulation: Moving Forward, Looking Back" at www.fdic.gov/bank/analytical/fyi/2003/011403fyi.html.
- 44 12 C.F.R. 3, Appendix A, Section 5(b).
- 45 12 C.F.R. 3.6(b).
- 46 12 C.F.R. 3.6(c).
- 47 76 F.R. 79382 (December 21, 2011).
- For the reasons expressed by Acting Comptroller Walsh in his testimony before the Senate Banking Committee, international consistency and
- 48 competitive equality are unlikely to be achieved. Realistically, even though the proper forum for consistency may be the Basel Committee, each country is free, and the US has exercised this freedom with Dodd Frank, to deviate from what the Basel Committee adopts or recommends.
- A bank applying the market-risk based capital rules must measure its market risk and, on a daily basis, hold capital to maintain an overall minimum
- 49 of 8% ratio of total qualifying capital to risk-weighted assets adjusted for market risk. See Trading Activities Manual at 2110.1.
- 76 F.R. 79381 (December 21, 2011). The Guidelines explain that "general market risks arises from changes in the level of interest rates on
- 50 Treasury securities, from changes in the credit spreads for all borrowers of similar credit quality, and from changes in foreign exchange rates. These general market risk factors affect the value of all positions in a bank's trading account that are driven by changes in interest rates, foreign exchange rates, or equity and commodity prices." *Id.*
- Under the current law, a bank that incorporates specific risk in its internal model has no specific risk surcharge if the bank demonstrates that its internal model adequately measures all aspects of specific risk, including default and event risk, of covered debt and equity positions. In reviewing the internal model, the prudential supervisor will take into account whether the internal model explains the historical price variation in the trading portfolio and captures concentrations. See 12 C.F.R. 3, Appendix B, Section 5(a) (1). If the bank fails to demonstrate that its internal model adequately measures all aspects of specific risk, including default and event risk, then the bank must calculate its specific risk surcharge by using
- 51 either an internal model that separates the value at risk measure into a specific risk portion and a general risk portion, and the specific risk surcharge equals the previous day's specific risk portion or an internal model that does not separates the value at risk measure into a specific risk portion and a general risk portion, and the specific risk surcharge equals the sum of the previous day's value at risk measure for subportfolios of covered debt and equity positions. 12 C.F.R. 3, Appendix B, Section 5(a) (2). If the bank does not use an internal model in compliance with Section 5 of Appendix B, then the bank must calculate its specific risk surcharge using the standard specific risk capital charge set forth in Section (c) of Appendix B. *Id.*
- According to the Guidelines, the standardized method for debt and securitization positions is calculated by multiplying the absolute value of the current market value of each net long position and net short position in a debt instrument by the appropriate specific risk-weighting factor. The
- 52 Guidelines also provide that specific risk-weighting factors range from zero to 8% and are based upon the identity of the obligor and, in the case of some positions, the credit rating and remaining contractual maturity of the position. The specific risk add-on for a derivative instrument is based on the market value of the effective notional amount of the underlying position. A bank may net long and short debt positions (including derivatives) in

identical debt issues or indices. A bank may also offset a "matched" position in a derivative and its corresponding underlying instrument. Under the standardized method, the specific risk add-on for equity positions is the sum of the bank's net long and short positions in an equity position, multiplied by a specific risk-weighting factor. A bank may net long and short positions (including derivatives) in identical equity issues or equity indices in the same market. The specific risk add-on is 8% of the net equity position, unless the bank's portfolio is both liquid and well-diversified, in which case the specific risk add-on is 4%. For positions that are index contracts comprising a well-diversified portfolio of equities, the specific risk add-on is 2% of the net long or net short position in the index. *Id.*

The Guidelines explain that "specific risk refers to factors that apply singularly to an identified position. For example, idiosyncratic credit risk associated with a particular issuer of a debt instrument – which makes the holder of that instrument vulnerable to losses due to the credit quality deterioration of the issuer, or its declaration of bankruptcy – is specific risk." *Id.*

Sovereign debt position means a direct exposure to a sovereign entity. A sovereign entity is a central government or an agency, department or central bank of a central government. A sovereign entity does not include commercial enterprises owned by the central government that are engaged in activities involving trade, commerce or profit, which are generally conducted or performed in the private sector. 76 F.R. 79384 (December 21, 2011). See also 76 F.R. 79402 at Section 10(b)(2).

The current 34 OECD member countries include Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, South Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States (*emphasis added*). Some may argue that this policy should be changed in light of the current economic crisis in Europe. Indeed, some would also point to the recent downgrades by the US and France as evidence that even the riches OECD members should not receive a 0% risk-weighting factor. Many investors are also likely to view the sovereign debt of Greece as more risky than the sovereign debt of Argentina and Brazil. Yet, the risk based capital rules suggest the opposite is true.

For example, Portugal, Ireland, Italy, Greece and Spain are OECD members, but China is not. Clearly, many investors believe sovereign debt of China is less risky than sovereign debt of Greece.

According to the OECD, "the Participants' country risk classification system uses a scale of eight risk categories (0-7). According to the rules of the Arrangement, the country risk classification of High Income OECD countries and other High Income Euro-zone countries is Category 0. While no minimum premium rates are set for transactions involving obligors in Category 0 countries, the premium rates charged should not undercut private market pricing. The country risk classifications of all other countries are determined through the application of a two-step methodology: A. The Country Risk Assessment Model ("CRAM") produces a quantitative assessment of country credit risk based on three groups of risk indicators (the payment experience of the Participants, the financial situation and the economic situation). B. A qualitative assessment of the CRAM results by country risk experts from OECD members, considered country-by-country to integrate political risk and/or other risk factors not taken (fully) into account by the CRAM. Accordingly, the final country risk classifications are achieved through a thorough discussion among experts and a consensus-building process. The country risk experts meet several times a year. These meetings are organised so as to guarantee that every country is reviewed whenever a fundamental change is observed and at least once a year. Although the meetings and details of the CRAM are confidential and no official reports of the deliberations are made publicly available, the list of country risk classifications is published after each meeting." See **Country Risk Classification** As of October 28, 2011, the CRC for the US was zero, but so was the CRC for Greece, Ireland, Italy, Portugal and Spain. The CRC for China was 2; the CRC for Argentina was 7; the CRC for Brazil was 3; the CRC for Hong Kong was 1; and the CRC for India was 3; See **Country Risk Classifications of the Participants to the Arrangement on Officially Supported Export Credit**

76 F.R. 79384 (December 21, 2011).

See 76 F.R. 79402 (December 21, 2011).

This advantage remains even though the Federal Banking Agencies recognize its shortcomings. For example, according to the Guidelines, "However, the agencies recognize that CRCs have certain limitations. While the OECD has published a general description of the methodology for CRC determinations, the methodology is largely principles-based and does not provide details regarding the specific information and data considered to support a CRC. Also, OECD-member sovereigns that are defined to be "high-income countries" by the World Bank are assigned a CRC of zero, the most favorable classification. As such, a CRC classification may not accurately reflect a high income OECD country's relative risk of default. Additionally, while the OECD reviews qualitative factors for each sovereign on a monthly basis, quantitative financial and economic information used to assign CRCs is available only annually in some cases, and payment performance is updated quarterly. The agencies are concerned that, in some cases, the CRC may misclassify risks for purposes of assessing risk-based capital requirements, particularly where sovereign debt restructuring has occurred. In such cases, the CRC appears to assess the risk associated with the sovereign's payment of the restructured debt and may not fully reflect the credit event associated with the restructuring." *Id.*

For these purposes, a default would mean noncompliance with external debt service obligations or the inability or unwillingness of a sovereign entity to service an existing obligation according to its terms, as evidenced by failure to make full and timely payments of principal and interest, arrearages or restructuring. The Guidelines assert that these risk weights are consistent with the Basel II standardized risk weights where a CRC 0-1 equals a Basel II risk weight of 0%; a CRC 2 equals a Basel II risk weight of 20%; a CRC 3 equals a Basel II risk weight of 50%; a CRC 4-6 equals a Basel II risk weight of 100%; and a CRC 7 equals a Basel II risk weight of 150%. Under Basel II, which relies upon credit ratings, for claims on a sovereign and its central banks, a credit rating of AAA to AA- equates to a 0% risk weight; a credit rating of A+ to A- equates to a 20%

risk weight; a credit rating of BBB to BBB- equates to a 50% risk weight; a credit rating of BB+ to B- equates to a 100% risk weight; a credit rating below B- equates to a 150% risk weight; and an unrated security equates to a 100% risk weight. See **Part 2: The First Pillar – Minimum Capital Requirements** at page 19.

62 76 F.R. 79385 (December 21, 2011).

A bank may assign to a sovereign debt position a risk-weighting factor lower than Table 4 shows if the position is denominated in the sovereign entity's currency, the bank has at least an equivalent amount of liabilities in that currency, and the sovereign entity allows banks under its

63 jurisdiction to assign the lower risk-weighting factor to the same position. Sovereign debt positions that are exposures to the US government and its agencies are always treated as having a CRC of 0 and a 0% risk-weighted factor, and sovereign debt positions of sovereign entities that have no CRC generally would be assigned an 8% risk-weighting factor. *Id.*

Multilateral Development Banks include the International Bank for Reconstruction and Development, the Multilateral Investment Guarantee Agency, the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the European Investment Fund, the Nordic Investment Bank, the Caribbean Development Bank, the Islamic Development Bank, the Council of Europe Development Bank, and any other multilateral lending institution or regional development bank in which the US is a shareholder or contributing member or which the bank's primary federal supervisor determines poses comparable credit risk. *Id.*

64 Government sponsored entities include the Federal Home Loan Mortgage Corporation (Freddie Mac"), the Federal National Mortgage Association ("Fannie Mae"), the Federal Farm Credit Bank System, the Farm Credit System Financial Assistance Corporation, the Student Loan Marketing Association, the Small Business Administration and the Export-Import Bank.

65 A government sponsored enterprise means an agency or corporation originally established or chartered by the US to serve public purposes specified by Congress, but whose obligations are not explicitly guaranteed by the full faith and credit of the US.

67 See 76 F.R. 79403 (December 21, 2011).

68 76 F.R. 79403 (December 21, 2011).

69 12 U.S.C. 1813.

70 12 C.F.R. 211.2 (excluding FDIC insured banks).

71 12 U.S.C. 1752.

72 76 F.R. 79387 (December 21, 2011).

73 Political subdivisions means a state, county, city, town or other municipal corporation, a public authority, and generally, any publicly owned entity that is an instrument of a state or municipal corporation. *Id.*

74 This new term and definition would exclude commercial companies owned by a government that engage in activities involving trade, commerce, or profit, which are generally conducted or performed in the private sector.

75 General obligation means a bond or similar obligation that is guaranteed by the full faith and credit of states or other political subdivisions of a sovereign entity. *Id.* at 79388.

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

77 76 F.R. 79403 (December 21, 2011).

78 The Federal Banking Agencies will permit this methodology only for publicly traded companies. The Federal Banking Agencies will not permit private companies to use this methodology because they believe private companies do not have the required market data. *Id.* at 79391.

79 Corporate debt position means a debt position that is an exposure to a company that is not a sovereign entity, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, a multilateral development bank, a depository institution, a foreign bank, a credit union, a Public Sector Entity, a Government Sponsored Enterprise, or a securitization. *Id.* at 79389.

Financial institution means: (A) A commodity pool as defined in section 1a(10) of the Commodity Exchange Act (7 U.S.C. 1a(10)); (B) A private fund as defined in section 202(a) of the Investment Advisors Act of 1940 (15 U.S.C. 80-b-2(a)); except for small business investment companies, as defined in section 102 of the Small Business Investment Act of 1958 (15 U.S.C. 662), or a private fund designed primarily to promote the public welfare, of the type permitted under section 24 (Eleventh) of the National Bank Act (12 U.S.C. 24 (Eleventh)) and 12 C.F.R. part 24; (C) An employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974 (29 U.S.C. 1002); (D) A bank holding company, depository institution, foreign bank, credit union, insurance company, or a securities firm, other than an entity selected as a Community Development Financial Institution (CDFI) under 12 U.S.C. 4701 et seq. and 12 CFR part 1805; (E) Any other company predominantly engaged in activities that are (i) in the business of banking under section 24 (Seventh) of the National Bank Act (12 U.S.C. 24), or (ii) in activities that are financial in nature under section 4(k) of the Bank Holding Company of 1956 (12 U.S.C. 1843(k)) as of the date this subpart becomes effective (collectively, "financial activities"); provided that, if the company is not an affiliate of the bank calculating its capital requirements under the Guidelines, then the bank may exclude activities set forth on Schedule A when determining whether the company is predominantly engaged in financial activities. (F) Any non-U.S. entity that would be covered by any of paragraphs (A) through (E) if such entity was organized in the United States; or (G) Any other company that an agency may determine is a financial institution based on the nature and scope of its activities.

(H) For the purposes of the proposed rule, a company would be predominantly engaged in financial activities, if: (i) 85% or more of the total consolidated annual gross revenues (as determined in accordance with applicable accounting standards) of the company in either of the two most recent calendar years were derived, directly or indirectly, by the company on a consolidated basis from financial activities; or (ii) 85% or more of the company's consolidated total assets (as determined in accordance with applicable accounting standards) as of the end of either of the two most recent calendar years were related to financial activities. For the purpose of determining whether a company is predominantly engaged in financial activities under the proposed definition, the Federal Banking Agencies have determined that certain financial activities may be excluded for determination regarding companies that are not affiliates of the bank. These activities are listed in Schedule A in the Guidelines. For purposes of the definition of financial institution, the Federal Banking Agencies would define affiliate with respect to a bank to mean any company that controls, is controlled by, or is under common control with, the bank.

81 *Id.* at 79390.

82 Table 11 covers specific risk-weighting factors for non-financial publicly-traded corporate debt positions, which shows EBITDA to assets ratio, stock return volatility and the specific risk-weighting factor percentage. *Id.*

83 The Federal Banking Agencies considered and declined to accept as an alternative to credit ratings a multi-indicator methodology similar to the methodology proposed for public companies that are not financial institutions, a bond credit spread methodology and a methodology based upon the OCC's revisions to the definition of investment grade because each such alternative was seen as having significant drawbacks or not being sufficiently developed. *Id.*

84 "Qualifying" means debt instruments that are: (A) rated investment grade by at least two nationally recognized credit rating services; (B) rated investment grade by one nationally recognized credit rating agency and not rated less than investment grade by any other credit rating agency; or (C) unrated, but deemed to be of comparable investment quality by the reporting bank and the issuer has instruments listed on a recognized stock exchange, subject to supervisory review. *Id.* at 79389.

85 Other means debt instruments that are included in the government or qualifying categories. *Id.*

86 See 76 F.R. 79404 (December 21, 2011).

87 For example, a banking organization pursuant to Section 10(b)(vi)(C)(1) must assign a specific risk-weighting factor of at least 8% to an interest only mortgage backed security that is not a securitization position.

88 See 76 F.R. 79404 (December 21, 2011).

89 See 76 F.R. 79404 (December 21, 2011), Section 10(b)(vii).

90 Under the Guidelines, a securitization is a transaction in which (A) all or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties; (B) the credit risk associated with the underlying exposures has been separated into at least two tranches that reflect different levels of seniority; (C) performance of the securitization position depends upon the performance of the underlying exposures; (D) all or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities); (E) for non-synthetic securitizations, the underlying exposures are not owned by an operating company; (F) the underlying exposures are not owned by a small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682); and (G) the underlying exposures are not owned by a firm, an investment in which qualifies as a community development investment under 12 U.S.C. 24 (Eleventh). *Id.* at 79394.

91 The Federal Reserve has highlighted four of the benefits of securitizations. First, the sale of assets may reduce regulatory costs by reducing both risk-based capital requirements and the reserves held against the deposits used to fund the sold assets. Second, securitization provides originators with an additional source of funding and liquidity since the process of securitization converts an illiquid asset into a security with greater marketability. Third, securitization may be used to reduce interest-rate risk by improving the institution's asset/liability mix. Fourth, the ability to sell these securities worldwide diversifies the institution's funding base, which reduces the bank's dependence on local economies. The Federal Reserve has also pointed out risks such as credit, liquidity, operational, legal and reputational risks in concentrations. See Trading Activities Manual at Section 3020.1; See also Asset Securitizations, Comptroller's Handbook (November 1997) at pages 1 and 4-5.

92 *Id.* at 79393.

93 *Id.*

94 *Id.*

95 See 76 F.R. 79405, Section 10(b)(vii)(E).

96 A re-securitization means a securitization in which one or more of the underlying exposures is a securitization position. Securitization position means a covered position that is an on-balance sheet or off-balance sheet credit exposure (including credit-enhancing representations and warranties) that arises from a securitization (including a re-securitization); or an exposure that directly or indirectly references a securitization exposure. *Id.* at 79394.

97 To use the SFA, a bank must meet minimum requirements under the Basel internal ratings-based approach to estimate probability of default and loss given default for the underlying exposures. Under US risk-based capital rules, the SFA is available only to banks that have been approved to use the advanced approaches. *Id.*

98 *Id.*

The simplified SFA is designed to apply relatively higher capital requirements to the more risky junior tranches of a securitization that are the first to absorb losses and relatively lower capital requirements to the most senior tranches. The simplified SFA is also designed to limit regulatory capital arbitrage by requiring more capital on a transaction-wide basis than would be required if the pool of assets had not been securitized.

Under the Guidelines, the simplified SFA specific risk-weighting factor for a position depends on the following inputs: (i) KG is the weighted-average capital requirement of the underlying exposures calculated using the agencies' general risk-based capital rules. (ii) Parameter A is the attachment point of the position. This represents the threshold at which credit losses would first be allocated to the position. This input is the ratio, expressed as a decimal value between zero and one, of the dollar amount of the securitization positions that are subordinated to the position to the dollar amount of the entire pool of underlying assets. (iii) Parameter D is the detachment point of the position. This represents the threshold at which credit losses allocated to the position would result in a total loss to the investor in the position. This input, which is a decimal value between zero and one, equals the value of Parameter A plus the ratio of (1) the dollar amount of the positions and all pari passu positions to (2) the dollar amount of the underlying exposures. (iv) A supervisory calibration parameter, p. For securitization positions that are not re-securitization positions, this input is 0.5; for re-securitization positions, it is 1.5. (v) Cumulative losses on the underlying pool of exposures, which affects the level of the specific risk-weighting factor floor. *Id.* at 79394. The Guidelines use these inputs to develop a mathematical formula: simplified SFA Formula

Where,

¹⁰¹*Id.* at 79395.

¹⁰²*Id.*

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