

## Key Aspects of the Interim Final Rule: Advanced Approaches Risk-Based Capital Rule and Market Risk Capital Rule

### Overview

To address weaknesses in the existing capital framework that were manifest during the recent financial crisis, the Basel Committee on Banking Supervision (BCBS) introduced a series of revisions to the advanced approaches risk-based capital framework in *Enhancements to the Basel II framework* (BCBS enhancements) and *Basel III: A global regulatory framework for more resilient banks and banking systems* (Basel III). In this interim final rule, the FDIC is adopting the BCBS enhancements, as discussed below, in a manner that is consistent with the requirements of section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

The interim final rule revises the FDIC's existing advanced approaches rules to improve and strengthen modeling standards, the treatment of counterparty credit risk and securitization exposures, as well as disclosure requirements. However, consistent with section 939A of the Dodd-Frank Act, the interim final rule does not include the BCBS enhancements to the ratings-based approach for securitization exposures because they rely on the use of credit ratings.

### Summary of the Interim Final Rule

#### *Counterparty Credit Risk*

#### **Credit Valuation Adjustment (CVA) Capital Requirement**

Consistent with Basel III, the interim final rule requires a bank to directly reflect CVA risk through an additional capital requirement. The CVA capital requirement is designed to address a potential increase in CVA due to changes in counterparty credit spreads.

Under the interim final rule, a bank may use one of two approaches to determine its CVA capital requirement: an advanced or simple CVA approach. The advanced CVA approach is based on the value-at-risk (VaR) model used by a bank to calculate specific risk under the market risk rule. In contrast, the simple CVA approach is based on the use of a supervisory formula and internally estimated probability-of-default.

#### **Exposures to Central Counterparties (CCPs)**

To incentivize the use of CCPs that satisfy internationally recognized standards for settling and clearing processes (that is, qualified central counterparties or QCCPs), the interim final rule adopts a more risk-sensitive treatment for transactions with CCPs, consistent with Basel III. Under the interim final rule, transactions conducted through a QCCP receive a more favorable capital treatment relative to those conducted through a CCP. Similarly, the interim final rule establishes a capital requirement for a bank's default fund contribution<sup>1</sup> to a CCP, with a more favorable capital treatment for default fund contributions to a QCCP relative to those to a CCP.

#### **Wrong-Way Risk, Margin Period of Risk, and Stressed Inputs**

The interim final rule requires a bank's risk-management processes to identify, monitor, and control wrong-way risk throughout the life of an exposure using stress testing and scenario analyses. In addition, the interim final rule improves the internal models methodology (IMM), which determines capital requirements for counterparty credit risk by employing stressed inputs and enhanced stress-testing analyses.

With respect to counterparty credit risk more generally, the interim final rule also increases the holding period and margin period of risk that a bank may use to determine its capital requirement for repo-style transactions, over-the-counter derivatives, and eligible margin loans to address liquidity concerns that arose in settling or closing-out collateralized transactions during the recent crisis.

#### *Asset Value Correlation*

To better recognize the correlation among financial institutions to common risk factors, the FDIC is incorporating a revised asset value correlation factor, which is used for determining the capital requirement for certain "wholesale" exposures—that is, exposures to unregulated financial institutions as well as exposures to regulated financial institutions with consolidated assets of greater than or equal to \$100 billion.

## *Securizations and Disclosures*

The BCBS enhancements amended the Basel internal ratings-based approach to require a banking organization to assign higher risk weights to resecuritization exposures than other similarly rated securitization exposures. Consistent with the BCBS enhancements, the interim final rule amends the supervisory formula approach in a manner that results in higher risk weights for resecuritization positions. The interim final rule also revises the definition of eligible financial collateral to exclude certain instruments that performed poorly during the crisis, such as resecuritization exposures.

Consistent with Section 939A of the Dodd-Frank Act, the interim final rule removes the ratings-based and the internal assessment approaches from the securitization hierarchy under the existing advanced approaches rule and substitutes in their place a simplified supervisory formula approach (SSFA).

Consistent with the BCBS enhancements, the FDIC is adopting certain other revisions to the securitization framework. The interim final rule improves risk-management practices with respect to securitization exposures by requiring banking organizations subject to the advanced approaches rules to conduct more rigorous credit analysis prior to acquiring such exposures. The interim final rule also requires enhanced disclosure requirements related to securitization exposures.

### *Other Revisions to Remove Credit Ratings*

The FDIC is replacing creditworthiness standards in the definitions of the existing advanced approaches rules that reference credit ratings. In general, the ratings-based standards are replaced with a new “investment grade” standard, which is defined as a determination by the bank that an entity to which the bank has exposure through a loan or security, or the reference entity with respect to a credit derivative, has adequate financial capacity to satisfy all commitments under the exposure for the projected life of the investment. Such an entity possesses an adequate capacity to meet financial commitments if its risk of default is low, and full and timely repayment of principal is expected.

In addition, the FDIC is revising the collateral haircut approach by removing references to credit ratings from the matrix used to determine the standard supervisory market price volatility haircuts applicable to certain forms of collateral. Under the interim final rule, the market price volatility haircut is based, in part, on the risk weight applicable to collateral under the Standardized Approach interim final rule.

### *Market Risk Rule*

Consistent with its new authorities under section 312 of the Dodd-Frank Act, the FDIC is revising the market risk rules to apply to state savings associations, as well as savings and loan holding companies. The Office of Thrift Supervision (OTS) did not implement the market risk capital rules for such institutions prior to its abolition under section 313 of the Dodd-Frank Act because, as a general matter, savings associations do not engage in trading activity to a substantial degree. However, the FDIC believes that any savings association or savings and loan holding company whose trading activity grows to the extent that it meets the thresholds should hold capital commensurate with the risk of the trading activity and should have in place the prudential risk management systems and processes required under the market risk capital rule.

The FDIC has also adopted conforming changes to certain elements of the market risk rule to reflect changes that are being made to other aspects of the regulatory capital framework. These changes are designed to correspond to the changes to the capital requirements for sovereign exposures that reference country risk classifications as well as the treatment of securitization exposures under the simplified supervisory formula approach. The FDIC has also made a technical amendment to the market risk rule with respect to the covered position definition. Previously, the definition of covered position excluded equity positions that are not publicly traded. The FDIC has refined this exception such that a covered position may include a position in a non-publicly traded investment company provided that all the underlying equities held by the investment company are publicly traded.

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<sup>1</sup> Default fund contributions refer to the funds contributed or commitments made by clearing members to a CCP's mutualized loss-sharing arrangement. Default funds are also known as clearing deposits or guaranty funds.