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RISK-BASED CAPITAL RULES

Notice of Proposed Rulemaking on Risk-Based Capital Standards: Standardized Framework

Summary: The federal bank and thrift regulatory agencies have jointly issued the attached Notice of Proposed Rulemaking (NPR) and are seeking comment on the domestic application of the Basel II standardized framework for all domestic banks, bank holding companies, and savings associations that are not subject to the Basel II advanced approaches rule. The FDIC will accept comments on the NPR through October 27, 2008.

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12 CFR Part 325
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Attachment:

- "Key Aspects of the Proposed Rule on Risk-Based Capital Guidelines: Capital Adequacy Guidelines; Standardized Framework"
- Notice of Proposed Rulemaking, Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Standardized Framework

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Highlights:

In the attached NPR, the agencies propose to implement a new optional framework for calculating risk-based capital based on the Basel II Standardized Approach to credit risk and the Basel II Basic Indicator Approach to operational risk. The proposal would:

- Expand the use of credit ratings for determining risk weights,
- Base risk weights for residential mortgages on loan-to-value ratios,
- Expand the types of financial collateral and guarantees available to banks to offset credit risk,
- Offer more risk-sensitive approaches for recognizing the benefits of mitigating credit risk,
- Increase the risk weight for certain short-term commitments,
- Improve the risk sensitivity of the risk-based capital requirements for securitizations and equity investments, and
- Institute a risk-based capital requirement for operational risk.

The NPR includes a series of requests for comment on the proposed implementation of the standardized framework. The agencies are also withdrawing the Basel 1A proposal issued on December 26, 2006.

Key Aspects of the Proposed Rule on Risk-Based Capital Standards: *Standardized Framework*

I. Introduction

The attached interagency Notice of Proposed Rulemaking (NPR) is based on the capital accord entitled “International Convergence of Capital Measurement and Capital Standards: A Revised Framework” (Basel II). The NPR explains how the federal bank and thrift regulatory agencies (agencies) propose to implement the Basel II standardized approach for assessing risk-based capital charges for credit risk and the Basel II basic indicator approach for assessing risk-based capital charges for operational risk in the United States (together, the standardized framework). In general, credit risk is the potential that a bank borrower or counterparty will fail to meet its financial obligations in accordance with agreed-upon terms. Operational risk generally is the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events.

The standardized framework in this NPR would be optional for all banks and savings associations (banks) that are not subject to the new Basel II advanced approaches rule (core banks). Those banks that are not core banks and do not want to adopt the standardized framework could remain under the general risk-based capital rules. The agencies are seeking comment in the NPR regarding the extent to which core banks could use the proposed standardized framework.

In July 2007, the agencies said that they would withdraw the Basel IA NPR and issue a proposed rule that would provide all banks that are not core banks with the option to adopt the standardized approach in the Basel II Accord.¹ The agencies also said the proposed standardized framework would be finalized before core banks begin the first transition period year under the advanced approaches rule.

¹ FDIC PR-64-2007, Joint Release, "Banking Agencies Reach Agreement on Basel II Implementation," July 20, 2007.

The standardized framework outlined in this proposal would provide U.S. banks the option to calculate their risk-based capital requirement in a manner that is more risk sensitive than the general risk-based capital rules, but is less complex than the advanced approaches rule. For some exposures such as corporate exposures, repo-style transactions, eligible margin loans, and collateralized OTC derivative transactions, the proposed rule allows a bank to choose the level of complexity for calculating the risk-based capital requirement. If a bank decides to use the standardized framework, all subsidiary depository institutions must also opt into the framework unless a depository institution notifies its primary federal supervisor of its intent to opt out and that supervisor does not object to the depository institution's intent to remain under the general risk-based capital rules.

II. The Proposed Rule

This NPR includes most aspects of the standardized approach for credit risk, the basic indicator approach for operational risk, and the relevant disclosure requirements provided in the Basel II Accord.² In certain instances, the NPR takes a different approach than the Basel II Accord to accommodate the unique characteristics and profile of the U.S. financial markets, most notably residential mortgages, and to make the proposal consistent with the relevant provisions in the advanced approaches rule. Where the NPR differs from the Basel II Accord, the FDIC believes that the differences are directionally consistent with the intent of the Accord and result in an appropriate application of the Basel II Accord in the United States.

The proposed standardized framework focuses primarily on refining the approach to calculating risk-weighted assets and generally would not change the definition of tier 1 or total capital in the general risk-based capital rules. The standardized framework also would not change prompt corrective action (PCA), the leverage ratio calculation, or the application of the market risk rule (MRR).³

² <http://www.bis.org/publ/bcbs107.pdf>.

³ See 12 CFR part 325.

This proposal groups a bank's exposures into three basic categories: general credit, securitization, and equity. To calculate the risk-weighted assets for exposures in these categories, a bank would determine the appropriate exposure amount and multiply that amount by the appropriate risk weight based on the obligor and taking into account any collateral or guarantee. The general risk-based capital rules permit the use of credit ratings issued by nationally recognized statistical rating organizations (NRSROs)⁴ only for securitization exposures. In contrast, the standardized framework generally would risk weight most types of exposures based on external or inferred ratings.

External and Inferred Ratings

The standardized framework relies directly on the use of credit ratings to assess the credit risk associated with individual exposures to sovereign entities, public sector entities (PSEs), corporations, and securitizations. The proposal limits the use of credit ratings to those issued by an NRSRO. The applicable external rating is the lowest NRSRO credit rating that is assigned to a particular exposure. If an exposure does not have an applicable external rating (unrated exposure), then the bank must attempt to infer a rating. Generally, under this NPR, an exposure receives a risk weight based on its applicable external or applicable inferred rating or absence thereof. For a securitization exposure, such as a tranching mortgage-backed security, the applicable rating is also based on the lowest external or inferred rating. A securitization exposure that has no applicable rating exposure is generally deducted from either tier 1 or total capital, depending upon the type of exposure.

In light of the recent events in the credit markets and related concerns with NRSRO ratings, the NPR seeks comment on the use of NRSRO ratings for risk-based capital purposes generally, on the question of solicited versus unsolicited ratings specifically, and on using ratings for securitization exposures. The FDIC is particularly interested in comments on the use of external ratings for determining risk-based capital

⁴ For example, Moody's, S&P, and Fitch.

requirements. The NPR also seeks comment on any additional refinements that would address more broadly the prudent use of NRSRO ratings by banks, including operational conditions related to the use of NRSRO ratings for certain securities, and enhancements to minimum capital requirements and the supervisory review process.

Pillar 1: Risk-Weighted Assets for General Credit Risk

Exposures to Sovereign Entities, PSEs, and Corporates. In the NPR, the applicable external or applicable inferred rating is the basis for determining the risk weight of an exposure to a sovereign entity,⁵ an exposure to a public-sector entity (PSE),⁶ or a corporate exposure.⁷ For these exposures, the lower the applicable external rating, the higher the risk weight.

Table 1 – Exposures to Sovereign Entities, PSEs, and Corporates

Applicable External or Applicable Inferred Rating	Example	Risk Weight (in percent)		
		Sovereign	PSE	Corporate
Highest investment grade rating	AAA	0	20	20
Second-highest investment grade rating	AA	0	20	20
Third-highest investment grade rating	A	20	50	50
Lowest-investment grade rating	BBB	50	50	100
One category below investment grade	BB	100	100	100
Two categories below investment grade	B	100	100	150
Three categories or more below investment grade	CCC	150	150	150
No applicable rating	N/A	100	50	100

⁵ For example, U.S. Treasury securities.

⁶ A PSE means a state, local authority, or other governmental subdivision below the sovereign entity level. Exposures to PSEs include revenue and general obligation bonds.

⁷ Corporates include exposures to a securities broker or dealer or an exposure to a government-sponsored enterprise such as Fannie Mae or Freddie Mac.

Table 2 – Short-term Corporate Exposures

Applicable external rating	Example	Risk Weight (in percent)
Highest investment grade	A-1/P-1	20
Second-highest investment grade	A-2/P-2	50
Third-highest investment grade	A-3/P-3	100
Below investment grade	B, C, and non-prime	150
No applicable external rating	NA	100

Exposures to Supranationals and Multilateral Development Banks: Exposures to certain supranationals (for example, the International Monetary Fund) and multilateral development banks (for example, the World Bank) would be risk weighted at zero percent.

Exposures to Depository Institutions, Foreign Banks and Credit Unions. For exposures to depository institutions, foreign banks, and credit unions, the risk weight is one step higher than the risk weight for the sovereign where the entity is incorporated. For example, the risk weight for an exposure to a U.S. depository institution would be 20 percent, which is one step higher than the zero percent risk weight accorded exposures to the United States, which has an issuer rating of AAA.

Residential Mortgage Exposures. The proposed rule uses loan-to-value (LTV) ratios to risk weight one-to-four family residential mortgages similar to the method that was proposed in the Basel IA NPR. LTV ratios are a simple and straightforward method to differentiate risk and the likelihood of borrower default. Under the NPR, an individual mortgage may receive a risk weight ranging from 20 to 150 percent, depending on the mortgage's LTV ratio. Past due residential mortgages would receive a 100 or 150 percent risk weight based on the LTV ratio of the mortgage.

First Lien Mortgages - In the proposed rule, a bank would use the risk weights in Table 3 for all first-lien mortgages or combined first and junior lien mortgages (for example, piggy-back loans) based upon the mortgage's LTV ratio at origination. The bank could not change the LTV ratio except as a result of loan amortization (positive or

negative) or if the mortgage is restructured. For the purposes of determining the LTV ratio, a bank could consider loan-level private mortgage insurance purchased from an insurer that is not affiliated with the bank, provided that the mortgage insurer has issued an outstanding long-term debt with an external rating within the top three external rating categories (that is, A- or better).

Stand-alone Junior Lien Mortgages - The FDIC continues to believe that stand-alone junior mortgage loans pose greater risk and necessitate a higher risk weight than a comparable first-lien mortgage. For a stand-alone junior lien mortgage, the proposed rule would require a bank to determine the combined LTV ratio calculated based on the amount of the first and junior liens. The bank would assign a risk weight according to Table 4 using the combined LTV of the loan. In addition, the proposed rule also requires a bank to hold risk-based capital for the unfunded portion of a home equity line of credit (HELOC) that is not unconditionally cancelable by applying the appropriate credit conversion factor⁸ and risk weight to the unfunded portion of the loan. For example, if a property is valued at \$400,000, the first mortgage is \$250,000 from bank A, the initial commitment for the 5-year HELOC is \$100,000 from bank B of which borrower has drawn down \$25,000 and the HELOC is not unconditionally cancelable, the computation of risk-weighted assets for the HELOC is as follows: The LTV for the funded HELOC is $\$250,000 + \$25,000$ divided by $\$400,000 = 68.75$; risk-weighted assets for the funded portion of the HELOC equal $\$25,000 \times 100\% = \$25,000$; the LTV for the unfunded HELOC is $\$250,000 + \$25,000 + \$75,000$ divided by $\$400,000 = 87.5$; and risk-weighted assets for the unfunded portion of the HELOC equal $\$75,000 \times 50\%$ (the CCF for a long-term commitment) $\times 100\% = \$37,500$. Total risk weighted assets for the HELOC would be $\$25,000 + \$37,500 = \$62,500$.

⁸ Unless the commitment is unconditionally cancellable, the CCF is 20% or 50%.

Table 3 - Risk Weights for First-Lien Residential Mortgage Exposures

Loan-to-value ratio (in percent)	Risk weight (in percent)
Less than or equal to 60	20
Greater than 60 and less than or equal to 80	35
Greater than 80 and less than or equal to 85	50
Greater than 85 and less than or equal to 90	75
Greater than 90 and less than or equal to 95	100
Greater than 95	150

Table 4 - Risk Weights for Stand-Alone Junior-Lien Residential Mortgage Exposures

Loan-to-value ratio (in percent)	Risk weight (in percent)
Less than or equal to 60	75
Greater than 60 and less than or equal to 90	100
Greater than 90	150

Mortgages with Negative Amortization Features – A mortgage that has a negative amortization feature also has a credit risk exposure in the form of an unfunded commitment. Therefore, the NPR clarifies that mortgage loans with negative amortization features must be risk weighted in the same manner as exposures that are unfunded commitments (for example, lines of credit). Under the proposed rule, the unfunded maximum negative amortization amount would be risk weighted separately from the funded amount of the loan.

Assume a banking organization originates a first-lien residential mortgage exposure with a negative amortization feature; the property is valued at \$100,000; the original and outstanding principal amount of the exposure is \$81,000; and the negative amortization feature has a 10 percent cap and extends for ten years (that is, the mortgage loan balance can contractually negatively amortize to 110 percent of the original balance over the next 10 years). The funded loan amount of \$81,000 has an 81 percent LTV

ratio, which is risk weighted at 50 percent (based on Table 3). The negative amortization feature is an unfunded commitment with a maximum contractual amount of \$8,100. It would receive a 50 percent CCF, resulting in an exposure amount of \$4,050. The loan amount of the unfunded portion would be \$81,000 funded amount plus the \$8,100 maximum contractual unfunded amount, resulting in an LTV of 89.1 percent. The unfunded commitment exposure amount of \$4,050 would, therefore, receive a 75 percent risk weight (based on Table 3). The total risk-weighted assets for the exposure would be \$43,538, as illustrated in Table 5:

Table 5 - Example of Proposed Risk-Based Capital Calculation for First-Lien Residential Mortgage Exposures with Negative Amortization Features

Funded Risk-Weighted Assets Calculation	
1) Amount to Risk Weight	\$81,000
2) Funded LTV Ratio = Funded Loan Amount / Property Value = \$81,000/\$100,000 =	81%
3) Risk Weight based on Table 7	50%
4) RW Assets for Funded Loan Amount = \$81,000 x .50 =	\$40,500
Unfunded Risk-Weighted Assets Calculation	
1) Exposure Amount = Unfunded Maximum Amount * CCF = \$8,100 x .50 =	\$4,050
2) Unfunded LTV Ratio = (Funded Amount + Unfunded Amount)/Property Value = (\$81,000 + \$8,100)/\$100,000 =	89.1%
3) Risk Weight based on Table 7	75%
4) RW Assets for Unfunded Amount = \$4,050 x 0.75	\$3,038
Total Risk-Weighted Assets for a Loan with Negative Amortizing Features	
RW Assets for Funded Amount + RW for Unfunded Amount = \$40,500 + \$3,038 =	\$43,538
Note: the funded and unfunded amount of the loan will change over time once the loan begins to negatively amortize.	

The NPR seeks comments on other risk-sensitive methods that could be used to segment residential mortgages by risk level. One such example would be using pricing

information from the Home Mortgage Disclosure Act, which most banks are currently required to report.

Regulatory Retail Exposures. This NPR proposes to risk weight retail exposures (regulatory retail exposures) at 75 percent, provided that the aggregate exposure amount to one obligor is no greater than \$1 million. A regulatory retail exposure must also be part of a well-diversified portfolio. These exposures include credit card and personal loans and small loans to businesses, but not residential mortgage, securitization, and equity exposures.

Past Due Loans. Under this NPR, all non-residential mortgage exposures that are 90 days or more past due or on non-accrual must be risk weighted at 150 percent.

Other Assets. For a number of other asset categories, this NPR proposes to use the risk weights that are currently provided in the general risk-based capital rules. For example, a zero percent risk weight would apply to cash owned and held in a bank's offices or in transit and a 20 percent risk weight would apply to cash in the process of collection.

Off-balance Sheet Exposures. Generally, this NPR proposes to treat off-balance sheet exposures in the same manner as under the general risk-based capital rules. The off-balance sheet exposure would be multiplied by a credit conversion factor (CCF) to determine the exposure amount and the exposure amount is multiplied by the appropriate risk weight to obtain the amount of risk-weighted assets. The CCFs would be the same as the CCFs in the general risk-based capital rules with the notable exception of short-term commitments that are not unconditionally cancelable, which would receive a 20 percent CCF. For example, a \$100,000 unfunded line of credit to an unrated corporation would be multiplied by the 20 percent CCF and then risk-weighted according to the risk weight of the obligor, in this case, a 100 percent risk weight ($\$100,000 \times 20\% = \$20,000$ of on-balance sheet exposure times a risk weight of 100% = \$20,000 of risk-weighted

assets). The FDIC believes that a 20 percent CCF for these short-term commitments better reflects the risk of these exposures.

Over-the-Counter (OTC) Derivative Contracts. Consistent with the Basel II Accord and similar to the approach in the general risk-based capital rules, this NPR uses the current exposure method⁹ to determine the exposure amount for a single OTC derivative contract or multiple OTC derivative contracts covered by a qualifying master netting agreement. The qualifying master netting agreement must satisfy certain requirements, which are consistent with the requirements in the advanced approaches rule. If the OTC derivative contract is collateralized, a bank could recognize the credit mitigating benefits of any financial collateral using the simple or the collateral haircut approaches proposed in the collateralized transactions section of this NPR.

Under this NPR and consistent with the Basel II Accord, the 50 percent risk weight for an OTC derivative contract is removed and the risk weight would be the appropriate risk weight for the counterparty or obligor. This NPR also describes the circumstances under which a risk-based capital requirement for counterparty credit risk for credit derivatives and equity derivatives is assessed.

Credit Risk Mitigation

Guarantees and Credit Derivatives. Consistent with the Basel II Accord and similar to the general risk-based capital rules and the advanced approaches rule, a bank may substitute the risk weight of an eligible guarantor for the risk weight of the hedged or protected exposure. For example, if a commercial loan is unconditionally guaranteed by the U.S. government, the bank may risk weight the loan at zero to reflect the credit worthiness of the U.S. government rather than 100 percent for that of the borrower.

This NPR proposes to recognize a wider range of guarantors and protection providers than is allowed under the general risk-based capital rules. Consistent with the

⁹ See 12 CFR part 325 Appendix A.II.E.

advanced approaches rule, eligible guarantor means a sovereign entity, certain supranational entities, certain government-sponsored enterprises, depository institutions, multilateral development banks, a bank or savings and loan holding company, or a foreign bank, as well as any other entity that has issued and has outstanding an unsecured long-term debt security without credit enhancement that has a long-term applicable external rating. The credit risk mitigation benefits of guarantees and credit derivatives are recognized to the extent that they satisfy certain eligibility requirements, which are consistent with the requirements provided in the advanced approaches rule.

Collateralized Transactions. Consistent with the Basel II Accord and the advanced approaches rule, the NPR proposes to expand the range of collateral that a bank may recognize (financial collateral). Subject to certain conditions, financial collateral would include long- and short-term debt instruments with applicable external ratings of at least BB- or A-3, respectively; publicly traded equity securities; certain money market mutual fund shares; and conforming residential mortgages, in addition to the collateral currently recognized under the general risk-based capital rules.

A bank could recognize the benefits of financial collateral for a particular type of collateralized transaction using one of several different approaches: the simple approach, which is generally consistent with the general risk-based capital rules; the collateral haircut approach, which includes supervisory haircuts and a bank's estimates of haircuts; or the simple VaR approach. Consistent with the advanced approaches rule, the collateral haircut approach may be used only for collateralized OTC derivative contracts, repo-style transactions, and eligible margin loans and the simple value-at-risk (VaR) approach may be used only for repo-style transactions and eligible margin loans.

Under the simple approach, for example, a \$100 loan to an unrated corporate collateralized by a \$80 long-term debt instrument rated AAA, the risk weighted asset amount would be $\$80 \times 20 \text{ percent} = \16 for the collateralized part of the loan and $\$20 \times 100 \text{ percent} = \20 for the uncollateralized part of the loan, or a total of \$36 of risk-weighted assets for the \$100 collateralized loan.

This NPR does not propose the Basel II internal models approach, which includes the expected positive exposure approach (EPE). EPE allows cross product netting for collateralized OTC derivative contracts, repo-style transactions, and eligible margin loans. The NPR seeks comment on whether the internal models approach should be included as an option in the U.S. standardized framework.

Under both the simple and collateral haircut approaches, a bank would have to calculate a counterparty risk-based capital requirement for certain capital market transactions such as repurchase, reverse repurchase, and securities lending and borrowing agreements.

Securitization and Equity Exposures

Definition of Securitization Exposures and Hedge Funds. Consistent with the advanced approaches rule, the proposal generally defines a securitization exposure as an exposure that involves the tranching of credit risk associated with the financial assets underlying the securitization exposure. For example, a security backed by mortgages that has a senior and one or more junior tranches as well as an equity or first loss tranche would qualify as a securitization exposure. In contrast, a pass-through mortgage backed security guaranteed by Freddie Mac or Fannie Mae that does not have tranching of credit risk would not be securitization exposure, rather it would be a corporate exposure.

Treatment of Securitization Exposures. The treatment for securitization exposures is generally similar to the ratings-based approach in the advanced approaches rule with the exception of the range of risk weights. A bank would deduct from capital all after tax gains-on-sale and credit-enhancing interest-only strips resulting from the origination of securitization exposures. A bank would continue to risk weight the securitization exposure according to the external rating of the exposure; however, the risk weight of a BB rated tranche would increase from 200 percent in the general risk-based capital rules to 350 percent. The credit conversion factor for a short-term eligible asset-backed commercial paper (ABCP) liquidity facility also would increase from 10 percent

to 20 percent, consistent with the proposed CCFs for other unfunded commitments. The FDIC believes that these changes better align capital with the risks in securitization.

The proposed rule would assess a risk-based capital charge for securitizations of revolving exposures with early-amortization features, for example, credit card securitizations. The early amortization capital charge would be assessed against the off-balance sheet investors' interest and would be imposed only in the event that the excess spread has declined to a predetermined level. A maximum capital charge would prevent the total capital charge for these securitization exposures from being greater than if the bank held the exposures on-balance sheet.

Equity Exposures. The proposed rule would risk weight equity exposures consistent with the simple risk weight approach (SRWA) in the advanced approaches rule. This approach assigns risk weights between based on Table 4 below.

Table 4 – Risk Weights for Equity Exposures

Risk Weight (in percent)	Equity Exposure
0	An equity exposure to a sovereign entity, certain supranationals, and any other entity whose credit exposures receive a zero percent risk weight under this proposed rule.
20	An equity exposure to a Federal Home Loan Bank or Farmer Mac
100	Community development equity exposures, the effective portion of a hedge pair, and non-significant equity exposures (less than 10 percent of tier 1 plus tier 2 capital)
300	A publicly traded equity exposure (other than an equity exposure that receives a 600 percent risk weight and including the ineffective portion of a hedge pair)
400	An equity exposure that is not publicly traded (other than an equity exposure that receives a 600 percent risk weight)
600	An equity exposure to an investment firm that (1) would meet the definition of a traditional securitization were it not for the primary Federal supervisor's decision to remove it from the securitization framework and (2) has greater than immaterial leverage

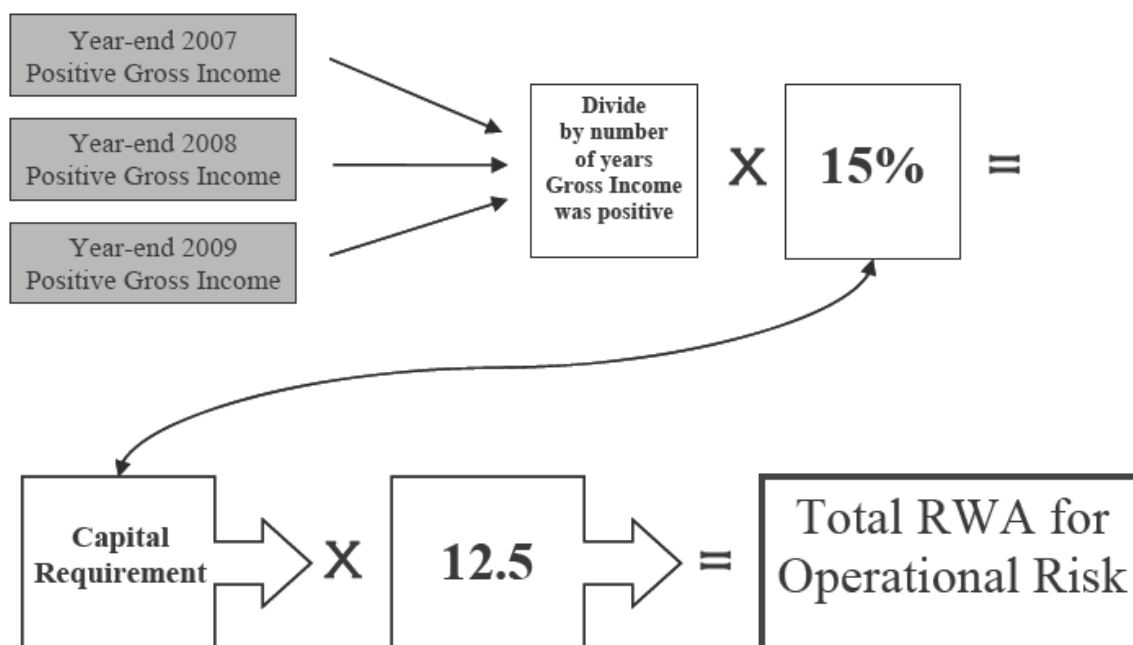
A bank would determine the risk-weighted asset amount for equity exposures to investment funds (for example, mutual funds) using one of four approaches that look through to the underlying assets of the exposure or the underlying assets the fund is permitted to hold. These approaches provide banks with more conservative methods if the necessary data on the underlying exposures is unavailable.

Operational Risk

The proposed rule requires a bank to determine the risk-based capital requirement for operational risk using the basic indicator approach (BIA). Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events. This definition also includes legal risk, which is the risk of loss (including litigation costs, settlements, and regulatory fines) resulting from the failure of the bank to comply with laws, regulations, prudent ethical standards, and contractual obligations in any aspect of the bank's business, but excludes strategic and reputational risks.

Under the BIA, a bank would calculate its risk-based capital requirement based on the average of the previous three years' positive gross income multiplied by 15 percent. A bank would exclude any year that gross income was negative or zero. Gross income would equal a bank's total net interest income plus non-interest income minus income from insurance and reinsurance activities. The capital requirement would be set at the beginning of the calendar year for the subsequent calendar year. For example, at year-end 2009, a bank would use gross income for 2007, 2008, and 2009 to calculate the capital requirement for all of 2010.

Chart 1 – Calculation of Operational Risk RWA



In the BIA, average positive gross income is used as a proxy for the measurement of operational risk. As a result, the lower a bank's gross income, the lower its operational risk charge would be. The NPR seeks comment on the proposed treatment of operational risk and the proposed average gross income calculation.

In addition to the BIA, Basel II Accord provides the advanced measurement approaches (AMA) for determining the operational risk capital requirement. Unlike the BIA, the AMA does not use gross income as a proxy for operational risk; rather, operational risk is assessed through the use of internal risk quantification systems. The NPR seeks comment on whether a final rule should provide the AMA as an option for calculating the operational risk-based capital requirement.

Total Risk-Based Capital Requirement.

The total risk-based capital requirement for a bank under this proposal includes the amount of capital determined by the application of the standardized approach and the amount determined for operational risk under the BIA and, for banks that use the market risk amendment, a market risk capital charge.

Pillar 2: Supervisory Oversight and Internal Capital Adequacy Assessment Process

The second pillar of the Basel II Accord, supervisory review, describes several principles that highlight the need for a bank to assess its capital adequacy relative to risk, and the need for supervisors to review and take appropriate actions in response to those assessments such as requiring additional buffer capital given the risk profile of the institution. While the NPR primarily focuses on the first pillar, minimum capital requirements, there are provisions within the proposed rule that would require supervisory review and an internal assessment of capital adequacy.

Pillar 3: Market Discipline

The third pillar of the Basel II Accord provides requirements that allow market participants to assess key information about an institution's risk profile and its associated level of capital, and provide for comparability across banks of risk elements. Increased disclosures are intended to allow an institution's stakeholders to evaluate more fully the institution's financial condition, including its capital adequacy. This greater transparency is critical to the development of effective market discipline.

The proposal requires the top-tier legal entity at the consolidated level, either the top-tier banking holding company or depository institution, if not under a holding company structure, to make certain mandatory disclosures on a quarterly basis. In addition to disclosing risk-based capital ratios and their components, the reporting entity must also report other information that is designed to enable market participants to better evaluate the bank's capital structure, risk exposure, risk management performance, and

capital adequacy. To further enhance transparency, the reporting entity is encouraged to post all disclosures made over the last three years in a single location on the bank's public website or some other readily accessible location.

The proposal requires each reporting entity to have a formal disclosure policy that is approved by the board of directors. This policy must provide for effective internal controls as well as disclosure controls and procedures to ensure that appropriate verification of the disclosure takes place.