



The Federal Banking Agencies' Regulatory Capital Proposals: Treatment of Derivatives and Collateral and Guarantees Mitigating Credit Risk Associated With Derivatives

On June 12, 2012, the federal banking agencies (the Office of the Comptroller of the Currency, the Federal Reserve Board and the Federal Deposit Insurance Corporation) formally proposed for comment, in a series of three separate but related proposals, substantial revisions to the U.S. regulatory capital regimen for banking organizations that, if adopted, will have a significant impact on the U.S. banking industry. One of these proposals, "Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements" (the "Proposal"),¹ details the extent to which banking organizations would, upon the Proposal's adoption, be required to hold risk-based capital for counterparty risk for derivatives transactions. The Proposal is based in significant part on the "standardized approach" for the weighting and calculation of risk-based capital requirements under the 2004-2006 Basel II Accord ("Basel II").² The method for determining risk-weighted assets for derivatives transactions, as for on-balance sheet exposures generally, is to multiply (i) the relevant risk weight by (ii) the relevant exposure amount.

The regime for risk-weighted assets contained in the Proposal is complex. However, the regulators' policy preference for cleared derivatives over non-cleared transactions is clear. In requiring significantly higher risk weights for non-cleared OTC transactions than for cleared transactions—indeed, the risk weight for a non-cleared transaction may be 50 times the risk weight for a cleared transaction—the Proposal implements the regulators' stated preference for cleared transactions.³

I. OTC Transactions

A. Risk Weights for OTC Transactions

Risk weights for OTC derivatives are generally a function of the counterparty the bank is facing.⁴ Under the Proposal, the highest risk weight currently applicable to OTC derivatives, 50 percent, would no longer apply. OTC derivatives would generally be subject to the general risk weights contained in Subpart D – Risk Weighted Assets – Standardized Approach, §_.32, General Risk Weights (the "General Risk Weight Provision"). Containing many more categories than the four categories contained in the current general risk-based capital requirements, the

¹ The other two proposals are (i) Implementation of Basel III; Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Periods and Prompt Corrective Action; and (ii) Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule.

² Basel Committee on Banking Supervision, *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (rev. comprehensive version June 2006).

³ "In general, [central counterparties] help improve the safety and soundness of the derivatives market through the multilateral netting of exposures, establishment and enforcement of collateral requirements, and promoting market transparency." Proposal, Supplementary Information, II.E.1 at 45.

⁴ However, special treatment applies to certain credit derivatives and equity derivatives. It appears that when banks use certain credit derivatives for purposes of credit mitigation, they will have the option to choose either the risk weight associated with the counterparty or the risk weight associated with the underlying exposure, so long as the treatment is consistent for all such transactions under the particular master agreement. See Subpart D – Risk Weighted Assets – Standardized Approach, §§_.34(c) and 36(c). In addition, banks must treat OTC equity derivatives as equity exposures and calculate a risk-weighted asset amount accordingly. Subpart D, _§34(d).

General Risk Weight Provision introduces new complexity to the determination of risk weights. By way of example, the risk weight categories include the United States and its agencies (risk weight of zero), domestic banks (generally, risk weight of 20 percent) and corporate exposures (risk weight of 100 percent). Sovereigns and foreign banks are subject to risk weights that range as high as 150 percent and are determined by reliance on the Organization for Economic Co-operation and Development (OECD) Country Risk Classification for the relevant country (rather than based on credit ratings, as in the original Basel II framework).⁵

B. Exposure Amounts for OTC Transactions

The exposure amount attributable to a derivatives transaction, or a set of derivatives transactions, is the sum of two components: first, a current exposure component and, second, a potential future exposure (“PFE”) component.

1. Single Swaps

The “current credit exposure” for a single derivatives transaction is the greater of the transaction’s mark-to-market value or zero.⁶ In other words, when a bank’s position under the transaction is flat or in-the-money to it, then the “current credit exposure” component counts as zero.

The PFE component of a single swap transaction equals the swap’s notional amount multiplied by a “Conversion Factor Matrix” contained in Subpart D, § __.34(a). The new proposed matrix has been updated from the one currently in effect to include additional categories of transactions. The conversion factors contained in the matrix are based on both the perceived volatility of the transaction type and the transaction’s remaining maturity. The factors range from zero, in the case of interest rate swaps with a remaining maturity of less than one year, to 15 percent, in the case of transactions of non-standard types with remaining maturities of more than five years.

2. Multiple OTC Derivatives Contracts

With regard to both current credit exposure and PFE, whether swap transactions that are subject to a single master agreement can be treated together as a “netting set” depends largely on whether the agreement is a “qualifying master netting agreement.” The essence of a “qualifying master netting agreement” is that the agreement will, upon an event of default, reliably permit a party to terminate, apply close-out netting, and promptly liquidate or set-off collateral, with the assurance that a party’s own default will not disqualify it from receiving a full termination payment.⁷

For multiple transactions under a qualified master netting agreement, the “net current credit exposure” is the greater of the sum of all mark-to-market values (both positive and negative) of the individual transactions subject to such agreement or zero.⁸ In other words, when the bank’s aggregate net position under all of such transactions is flat or in-the-money to it, then the net current exposure amount will be zero.

For multiple transactions subject to a qualifying master netting agreement, the relevant PFE amount is not calculated by simply adding the PFE amounts for each individual transaction. Instead, a formula determines an “adjusted sum of the PFE amounts” in which a portion of the sum of the PFE amounts is multiplied by a fraction (equal to the ratio of the net current exposure to the gross current exposure) that should equal less than one in a great many cases and should often be far less than one when there are numerous transactions under the same

⁵ The other categories of risk weights contained in the General Risk Weight Provision that are most relevant to the derivatives market relate to supranational entities, U.S. public sector entities and foreign public sector entities.

⁶ Subpart D, § __.34(a)(1)(i).

⁷ See Proposal, Addendum 2: Definitions Used in the Proposal, at 177.

⁸ Subpart D, § __.34(a)(2)(i).

qualifying master netting agreement.⁹ The use of this fraction as a factor in the formula ensures what should in most cases be a significant benefit of using a qualifying master netting agreement.

II. Cleared Transactions

The Proposal establishes risk weightings that, in comparison with those for OTC transactions, are highly favorable for transactions that are cleared through qualifying central counterparties, or QCCPs. The General Risk Weight Provision generally applies risk weights of at least 20 percent to counterparties other than the United States and its agencies, the highest rated sovereigns, and certain supranational entities and multilateral development banks. In contrast, the risk weights generally applicable in relation to QCCPs are 2 percent and 4 percent.

Broadly, QCCPs are defined as central counterparties that are (i) designated financial market utilities under Title VIII of the Dodd-Frank Act, (ii) if located outside the United States, similarly regulated and supervised, or (iii) otherwise demonstrated to the satisfaction of the relevant agency to be in sound financial condition and subject to effective regulatory oversight and risk management standards, with full collateralization on a daily basis.¹⁰ In practice, most central counterparties would likely qualify under (iii); a Title VIII designation will be limited to a small handful of clearing entities that have been deemed “systemically important.”

A. Bank as Clearing Member Client

When a bank is a clearing member client, exposure amounts for its cleared transactions are generally calculated in the same manner as exposure amounts for OTC derivatives, except that when the collateral posted by the clearing member client bank is held in a manner that is not bankruptcy remote, then the trade exposure amount also includes the value of that collateral.¹¹

The risk weightings for transactions cleared through QCCPs are generally significantly lower than for OTC transactions. The risk weight will be 2 percent if, among other things, “the collateral posted by the [bank] to the QCCP or clearing member is subject to an arrangement that prevents any losses to the clearing member client due to the joint default or a concurrent insolvency, liquidation, or receivership proceeding of the clearing member and any other clearing member clients of the clearing member.”¹² If the central counterparty is a QCCP but no such arrangement is in place, then the risk weight will be 4 percent.¹³

If the central counterparty does not qualify as a QCCP, the relevant risk weight will be determined in accordance with the General Risk Weight Provision as the risk weight appropriate for such central counterparty;¹⁴ this would likely be considered as a corporate-type exposure with a risk weight of 100 percent. The General Risk Weight Provision will also determine the risk weight in relation to collateral posted by a bank in an arrangement that is not bankruptcy remote. If the collateral is bankruptcy remote from each of the central counterparty, the clearing member and other clearing member clients of that clearing member, then no risk weight applies to such collateral.¹⁵

B. Bank as Clearing Member

The risk weight rules for banks as clearing members are similar to those for banks as clearing member clients. Trade exposure amounts for cleared transactions are generally calculated in the same manner as are exposure amounts for OTC derivatives transactions, except that, when the collateral posted by the clearing member bank is

⁹ See Subpart D, § __.34(a)(2)(ii).

¹⁰ See Proposal, Addendum 2: Definitions Used in the Proposal, at 176.

¹¹ See Subpart D, § __.35(b)(2).

¹² Subpart D, § __.35(b)(3)(i)(A).

¹³ Subpart D, § __.35(b)(3)(i)(B).

¹⁴ Subpart D, § __.35(b)(3)(ii).

¹⁵ Subpart D, §§ __.35(b)(4).

held in a manner that is not bankruptcy remote, then the trade exposure amount also includes the fair value of that collateral.¹⁶

There are only two risk weights that may apply to cleared transactions for a bank acting as a clearing member. If the central counterparty is a QCCP, then the risk weight will be 2 percent. If the central counterparty is not a QCCP, then the risk weight will be determined in accordance with the General Risk Weight Provision, which will also determine the risk weight for collateral that is not held in a bankruptcy remote manner.¹⁷

Where a bank is a clearing member of a central counterparty, a risk weighting will also apply to its contributions to that central counterparty's default fund. The entire amount of a default fund contribution to a central counterparty that is not a QCCP is subject to a risk weight of 1,250 percent—capital must be held essentially on a dollar-for-dollar basis. In relation to default fund contributions to QCCPs, the Proposal contains complex formulae aimed at, first, calculating the amount of capital that a QCCP would, if it were a bank, be required to maintain; second, comparing that hypothetical capital requirement with the amount of the QCCP's default fund that is funded by the QCCP itself; and third, allocating back to each clearing member its portion of the capital requirement.¹⁸ A risk weight of 1250 percent applies only to the amount equaling the clearing member's portion of the QCCP's hypothetical capital requirement; much lower risk weights apply to any contributions in excess of this amount.

III. Treatment of Credit Risk Mitigants

A. Financial Collateral

There are two distinct options for banks who wish to recognize the credit risk mitigating effects of financial collateral posted under qualifying master netting agreements, the “simple approach” and the “collateralized haircut approach.”

Under the simple approach, to the extent a derivatives exposure is collateralized, a bank may substitute for the risk weight of the derivatives exposure an alternative risk weight relating instead to the collateral. As a general rule, the risk weight assigned to the collateralized portion of the relevant exposure must be at least 20 percent.¹⁹ However, there are exceptions to the 20 percent floor. A risk weight of zero may apply when the collateral consists of “cash on deposit,” or when the collateral is an exposure to a sovereign that qualifies for a zero risk weight under the General Risk Weight Provision and the bank discounts by 20 percent the market value of the collateral. In addition, a 10 percent risk weight may apply when there is a daily margin maintenance requirement and the collateral is an exposure to a sovereign that qualifies for a zero risk weight under the General Risk Weight Provision.²⁰

Under the collateralized haircut approach, the exposure amount is determined by means of a mathematical formula under which the value of the collateral is subtracted from the exposure amount for the relevant transactions, and then upward adjustments are made for both the market price volatility for the collateral and mismatches between a settlement currency and the currency in which posted collateral is denominated. With respect to these adjustments, a bank may use either haircuts set out in the Proposal or, with regulatory approval, its own internal estimates for haircuts.²¹ The collateralized haircut approach requires sophisticated mathematics to determine its effect and is expected to be employed only by complex banks.

¹⁶ Subpart D, § __.35(c)(2)(i).

¹⁷ Subpart D, §§ __.35(c)(3) and (4).

¹⁸ Subpart D, § __.35(d); see also discussion at Proposal, Supplementary Information, II.E.3 at 50-51.

¹⁹ Subpart D, § __.37(b)(2).

²⁰ Subpart D, § __.37(b)(3).

²¹ Subpart D, § __.37(c).

B. Guarantees

Similar to the “simple approach” for collateral, the Proposal permits a bank to substitute for the risk weight associated with an exposure the risk weight associated with an eligible guarantor.²² The Proposal would significantly expand the types of eligible guarantors beyond those currently permitted. Such guarantors would include sovereigns, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, Federal Home Loan Banks, Farmer Mac, multilateral development banks, depository institutions, bank holding companies, savings and loan holding companies, credit unions, foreign banks, and investment grade rated corporations (other than monoline insurers or similar entities) whose credit is not positively correlated with the credit risk of the exposures that it is guaranteeing.²³ In order to qualify as eligible, a guarantee must satisfy several requirements designed to ensure that the guarantee is unconditional (there is one limited exception for certain conditional guarantees by the U.S. government), readily accessible, and enforceable.²⁴ Partial substitutions of the risk weight associated with an eligible guarantor are permitted when an eligible guarantee is limited in amount or has a remaining maturity shorter than that of the underlying obligation.

For a fuller description of the Proposals and their effects, please see our news bulletin “The Federal Banking Agencies’ Regulatory Capital Proposals – A Summary” – (at <http://www.mofo.com/files/Uploads/Images/120613-Federal-Banking-Agencies-Regulatory-Capital-Proposals-Summary.pdf>) and our client alert “The Banking Agencies’ New Regulatory Capital Proposals” (at <http://www.mofo.com/files/Uploads/Images/120613-Banking-Agencies-New-Regulatory-Capital-Proposals.pdf>).

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²² Subpart D, § 1.36(a).

²³ Proposal, Addendum 2: Definitions Used in the Proposal, at 165-66.

²⁴ Proposal, Addendum 2: Definitions Used in the Proposal, at 164-65.