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12 CFR Parts 607, 614, 615, et al.

Regulatory Capital Rules: Regulatory Capital, Implementation of Tier 1/Tier 2 Framework; Proposed Rule

FARM CREDIT ADMINISTRATION**12 CFR Parts 607, 614, 615, 620 and 628**

RIN 3052-AC81

Regulatory Capital Rules: Regulatory Capital, Implementation of Tier 1/Tier 2 Framework

AGENCY: Farm Credit Administration.

ACTION: Proposed rule.

SUMMARY: The Farm Credit Administration (FCA or we) is seeking comments on this proposed rule that would revise our regulatory capital requirements for Farm Credit System (System) institutions to include tier 1 and tier 2 risk-based capital ratio requirements (replacing core surplus and total surplus requirements), a tier 1 leverage requirement (replacing a net collateral requirement for System banks), a capital conservation buffer, revised risk weightings, and additional public disclosure requirements. The revisions to the risk weightings would include alternatives to the use of credit ratings, as required by section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

DATES: You may send us comments by January 2, 2015.

ADDRESSES: For accuracy and efficiency reasons, please submit comments by email or through the FCA's Web site. We do not accept comments submitted by facsimile (fax), as faxes are difficult for us to process in compliance with section 508 of the Rehabilitation Act. Please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

- *Email:* Send us an email at reg-comm@fca.gov.
- *FCA Web site:* <http://www.fca.gov>. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."
- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments.
- *Mail:* Barry F. Mardock, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of all comments we receive at our office in McLean, Virginia, or from our Web site at <http://www.fca.gov>. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, but for

technical reasons we may omit items such as logos and special characters. Identifying information you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove email addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT: J.C. Floyd, Senior Capital Markets Specialist and FCA Examiner, Office of Examination, Farm Credit Administration, McLean, VA 22102-5090, (720) 213-0924, TTY (703) 883-4056; or Rebecca S. Orlich, Senior Counsel, or Jennifer A. Cohn, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4056.

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I. Introduction

A. Objectives of Proposed Rule

The FCA's objectives in proposing this rule are:

- To modernize capital requirements while ensuring that institutions continue to hold enough regulatory capital to fulfill their mission as a Government-sponsored enterprise (GSE);
- To ensure that the System's capital requirements are comparable to the Basel III framework and the standardized approach that the Federal banking regulatory agencies have adopted, but also to ensure that the rules take into account the cooperative structure and the organization of the System;
- To make System regulatory capital requirements more transparent; and
- To meet the requirements of section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

B. Overview of Proposed Rule

The FCA is seeking public comment on a proposed rule that would revise our capital requirements governing

System banks,¹ System associations, Farm Credit Leasing Services Corporation, and any other FCA-chartered institution the FCA determines should be subject to this rule (collectively, System institutions). The proposed rule, where appropriate, is comparable to the capital rules adopted in October 2013 and April 2014 by the Federal banking regulatory agencies² for the banking organizations they regulate.³ Those rules follow the Basel Committee on Banking Supervision's (BCBS or Basel Committee) document entitled "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" (Basel III), including subsequent changes to the BCBS's capital standards and BCBS consultative papers, and our proposed rule follows Basel III as appropriate for cooperatives.⁴

The FCA believes this proposed rule would improve the quality and quantity of System institutions' capital and enhance risk sensitivity in calculating risk-weighted assets. It would also provide a more transparent picture of System institutions' capital to the investment-banking sector, which could facilitate System institutions' securities offerings to third-party investors. In addition, to comply with section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act),⁵ we propose alternatives to credit ratings for calculating risk-weighted assets for certain exposures that are currently based on the ratings of nationally

recognized statistical rating organizations (NRSROs).

After the worldwide financial crisis that began in the past decade, the BCBS issued Basel III and has continued to issue additional standards, with the goal of strengthening the capital of financial organizations. The capital rules recently adopted by the Federal banking regulatory agencies reflect Basel III as well as aspects of Basel II and other BCBS standards. The provisions of the banking agencies' rules that are not specifically included in the Basel III framework are generally consistent with the goals of the framework.

The FCA's proposed rule is comparable to the standardized approach rules of the Federal banking regulatory agencies to the extent appropriate for the System's cooperative structure and status as a GSE with a mission to provide a dependable source of credit and related services for agriculture and rural America. Like the banking agencies' rules, the FCA's proposed rule incorporates key aspects of the Basel III tier 1 and tier 2 framework and includes a leverage ratio as well as a capital conservation buffer to enhance the resilience of System institutions. The capital conservation buffer would be phased in over 3 years, but we are not proposing to incorporate any of the other transition periods in Basel III and the Federal regulatory banking agencies' rules.

The proposed rule would impose some new patronage and redemption restrictions, including FCA prior approvals, on System institutions in order to ensure the stability and permanence of the capital includable in the tier 1 and tier 2 capital ratios, especially regarding the equities held by the cooperative members of the institutions (common cooperative equities). The proposed rule would also require additional recordkeeping and disclosures by System institutions. We believe that the benefits to the System of these proposed rules would more than outweigh the restrictions and additional responsibilities we would require.

The FCA also proposes changes to its risk-based capital rules for determining risk-weighted assets—that is, the calculation of the denominator of a System institution's risk-based capital ratios. This proposed rule would eliminate the credit ratings of NRSROs from risk-weights for certain exposures, consistent with section 939A of the Dodd-Frank Act. As an alternative, FCA proposes to include methodologies for determining risk-weighted assets for exposures to sovereigns, foreign banks, and public sector entities, securitization

¹ For purposes of this preamble and proposed part 628, as well as some of the regulations in which we are proposing conforming changes and other existing regulations, the term "System bank" includes Farm Credit Banks, agricultural credit banks, and banks for cooperatives. It has the same meaning as Farm Credit bank, which is defined in § 619.9140 and which would continue to be used in some of the regulations in which we are proposing conforming changes as well as in other existing regulations. The Farm Credit Act of 1971, as amended (Farm Credit Act), uses the term "System bank" in a number of its provisions.

² The Federal regulatory banking agencies are the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), and the Federal Deposit Insurance Corporation (FDIC).

³ 78 FR 62018 (October 11, 2013) (final rule of the OCC and the FRB); 79 FR 20754 (April 14, 2014) (final rule of the FDIC).

⁴ Basel III was published in December 2010 and revised in June 2011. The text is available at <http://www.bis.org/publ/bcbs189.htm>. The BCBS was established in 1974 by central banks with bank supervisory authorities in major industrial countries. The BCBS develops banking guidelines and recommends them for adoption by member countries and others. BCBS documents are available at <http://www.bis.org>. The FCA does not have representation on the Basel Committee, as do the Federal banking regulatory agencies, and is not required by law to follow the Basel standards.

⁵ Pub. L. 111–203, 124 Stat. 1376 (2010).

exposures, and counterparty credit risk. The rule includes new risk weights for cleared transactions, guarantees including credit derivatives, collateralized financial transactions, unsettled transactions, and securitization exposures. In addition, there are proposed new disclosure requirements for all System banks related to regulatory capital instruments.

We generally do not propose risk weightings for exposures that System institutions have no authority to acquire.⁶ In some but not all cases, we discuss in this preamble this variance from the rules of the Federal banking regulatory agencies. In addition, we do not propose risk weightings for certain exposures that are both complex and unlikely; in the unlikely event that a System institution did acquire such an exposure, we would address it on a case-by-case basis using the reservation of authority that we propose. We generally discuss these exposures in this preamble.

We remind System institutions that the presence of a particular risk weighting does not itself provide authority for a System institution to have an exposure to that asset or item. System authorities to acquire exposures are contained in other provisions of our regulations and in the Farm Credit Act.

We are not proposing to adopt the “advanced approaches” regulatory capital rules because no System institution has the volume of assets or foreign exposures that would subject it to those approaches if it were regulated by a Federal banking regulatory agency.⁷ We also do not propose the market risk requirements, because no System institution has significant exposure to market risk, and we propose to require all System institutions to exclude Accumulated Other Comprehensive Income (AOCI) from regulatory capital.

We propose to place the tier 1 and tier 2 risk-weighted and leverage capital requirements in a new part 628 of FCA regulations in Title 12 of the Code of Federal Regulations. We would rescind the risk-weighting provisions in subpart H of part 615 and the core surplus, total surplus, and net collateral requirements in subpart K of part 615. We would

⁶ However, we do propose risk weighting for exposures that System institutions are not permitted to acquire under their investment authorities, because such exposures could be acquired through foreclosure on collateral or similar transactions.

⁷ In general, the advanced approaches rule applies to banks with consolidated total assets of at least \$250 billion or with foreign exposures of \$10 billion or more. Only two System institutions have total assets in excess of \$50 billion, and foreign exposures are negligible.

retain in part 615 the requirements for the numerator of the permanent capital ratio, a measure that is mandated by the Farm Credit Act, but the risk weightings for the denominator of the permanent capital ratio would be the risk weightings in new part 628. We also propose conforming changes in several other FCA regulations.

In this proposed rule, we have used the general format and the section and paragraph numbering system of the Federal banking regulatory agencies’ rules to the extent possible. In many cases, we have retained the numbering system by reserving sections and paragraphs where we are not proposing parallel provisions. We have done so in order to facilitate the comparison of the proposal with the banking agencies’ rules.

C. List of Questions Asked and Comments Requested in This Preamble

We welcome comments on every aspect of this proposed regulation, but there are certain areas where we are specifically seeking comment. We ask specific questions in these areas throughout this preamble, but for the convenience of commenters we provide below a list all of our specific questions and requests for comment. We also ask generally for comments that suggest how we could simplify the rule while retaining the improved capital framework that is our goal.

(1) Alternatives to Including Common Cooperative Equities in CET1 or Tier 2 Capital

We seek comment on using alternative terms or conditions that FCA could apply to common cooperative equities. Is a 10-year revolvment cycle long enough to reduce the expectation of redemption and increase the permanence of such equity instruments so that they may be included in CET1 capital?

(2) Capital Treatment of MSAs

We seek comment on whether FCA should risk weight MSAs at 100 percent or require deduction of MSAs from CET1, as we propose to do for non-mortgage servicing rights. At the present time, FCA does not consider any type of servicing asset material to a System institution’s or the System’s consolidated balance sheet.

(3) Accounting for Defined Benefit Pension Fund Assets

Given System institutions’ differing methods of reporting defined benefit pension fund assets, what is the best way to require adjustments for defined

benefit pension fund assets in the CET1 capital computation?

(4) Third-Party Capital Limits

We seek comment on alternative third-party limits to ensure that System institutions remain capitalized primarily by their member borrowers.

(5) Risk-Weighting—Exposures to OFIs

We seek comment on our proposed capital treatment of exposures to OFIs. Specifically, what factors or other information would be relevant if we consider assigning an intermediate risk-weight to a System institution’s exposure to an OFI, recognizing that the same exposure to the same OFI would receive a 100-percent risk weight from a banking organization regulated by a Federal banking regulatory agency?

(6) Risk-Weighting—Exposures to Certain Electrical Cooperative Assets

We seek comment as to whether we should retain this risk weighting [for exposures to certain electrical cooperative assets], being mindful of the Dodd-Frank Act section 939A requirement that we must eliminate the credit rating criteria.

(7) Credit Conversion Factors for Off-Balance Sheet Items—Exposure Amount of a System Bank’s Commitment to an Association

We invite comment on this determination [regarding our determination of the exposure amount of a System bank’s commitment to an association].

(8) System Institution Acting as Clearing Member

We invite comment as to whether we should adopt such provisions [contemplating that System institutions would act as clearing members].

(9) Collateralized Transactions—Own Estimate of Haircuts

We seek comment on whether we should adopt a regulation that would permit the use of an institution’s own estimates.

(10) Exposures to Asset-Backed Commercial Paper (ABCP) Programs

We seek comment as to whether we should include provisions in our risk-based capital rules regarding ABCP programs that are comparable to those adopted by the Federal banking regulatory agencies.

(11) Disclosures

We invite comment on the appropriate application of these proposed disclosure requirements to System banks.

D. Key Provisions of the Proposed Rule

TABLE 1—SUMMARY OF KEY PROVISIONS OF THE TIER 1/TIER 2 CAPITAL ITEMS AND STANDARDIZED APPROACH RISK WEIGHTS

Minimum capital ratios	Proposed treatment
Tier 1/Tier 2—Capital Items	
Common equity tier 1 (CET1) capital ratio (§ 628.10)	A minimum requirement of 4.5 percent.
Tier 1 capital ratio (§ 628.10)	A minimum requirement of 6.0 percent.
Total capital ratio (§ 628.10)	A minimum requirement of 8.0 percent.
Tier 1 Leverage ratio (§ 628.10)	A minimum tier 1 leverage ratio requirement of 5.0 percent of which at least 1.5 percent must consist of unallocated retained earnings and unallocated retained earnings equivalents. Applies to all System institutions.
Components of Capital and Eligibility Criteria for Regulatory Capital Instruments (§§ 628.20, 628.21, and 628.22).	Describes the eligibility criteria for regulatory capital instruments and adds certain adjustments to and deductions from regulatory capital, including increased deductions for mortgage servicing assets (MSAs) and deferred tax assets (DTAs).
Capital Conservation Buffer (§ 628.11)	A 2.5-percent capital conservation buffer of CET1 capital above the minimum risk-based capital requirements, which must be maintained to avoid restrictions on capital distributions and certain discretionary bonus payments.
Risk-Weighted Assets—Standardized Approach	
Credit exposures to:	Remains unchanged from existing regulations:
U.S. government and its agencies	0 percent.
U.S. depository institutions and credit unions (including those that are OFIs).	20 percent.
U.S. public sector entities, such as states and municipalities	20 percent—general obligations.
Cash	50 percent—revenue obligations.
Cash items in the process of collection	0 percent.
Exposures to other System institutions that are not deducted from capital.	20 percent.
Assets not specifically assigned to a risk weight category and not deducted from capital (§ 628.32).	100 percent.
Exposures to certain supranational entities and multilateral development banks (§ 628.32).	Risk weight reduced from 20 percent to 0 percent.
Exposures to Government-sponsored enterprises (§ 628.32)	Risk weight for preferred stock increased from 20 percent to 100 percent. Risk weight for all other exposures (except equity exposures, which are discussed below) remains at 20 percent.
Credit exposures to:	Introduces a risk-sensitive treatment using the Country Risk Classification measure produced by the Organization for Economic Cooperation and Development instead of determining risk weight based on OECD membership status.
Foreign sovereigns.	
Foreign banks.	
Foreign public sector entities (§ 628.32)	
Corporate exposures (§ 628.32)	Assigns a 100-percent risk weight to corporate exposures, including exposures to OFIs that do not satisfy the criteria for a 20-percent risk weight and agricultural borrowers.
Residential mortgage exposures (§ 628.32)	50 percent for first lien residential mortgage exposures that satisfy specified underwriting criteria. 100 percent otherwise.
High volatility commercial real estate exposures (§ 628.32)	Introduces a 150-percent risk weight for certain credit facilities that finance the acquisition, development, or construction of real property.
Past due exposures (§ 628.32)	Introduces a 150-percent risk weight for exposures that are past due, unless they are residential mortgage exposures or they are guaranteed or secured by financial collateral.
Off-balance Sheet Items (§ 628.33)	Certain credit conversion factors (CCF) revised, including the CCF for short-term commitments that are not unconditionally cancellable, which is increased from 0 percent to 20 percent.
OTC Derivative Contracts (does not include cleared transactions) (§ 628.34).	Modifies derivative matrix table slightly. Recognizes credit risk mitigation of collateralized OTC derivative contracts.
Cleared Transactions (§ 628.35)	Provides preferential capital requirements for cleared derivative and repo-style transactions (as compared to requirements for non-cleared transactions) with central counterparties that meet specified standards.
Guarantees and Credit Derivatives (§ 628.36)	Provides a more comprehensive recognition of guarantees.
Collateralized Transactions (§ 628.37)	Recognizes financial collateral.
Unsettled Transactions (§ 628.38)	Risk weight depends on number of business days past settlement date.
Securitization Exposures (§§ 628.41, 628.42, 628.43, 628.44, and 628.45).	Replaces the ratings-based approach with either the standardized supervisory formula approach (SSFA) or the gross-up approach for determining a securitization exposure's risk weight based on the underlying assets and exposure's relative position in the securitization's structure.

TABLE 1—SUMMARY OF KEY PROVISIONS OF THE TIER 1/TIER 2 CAPITAL ITEMS AND STANDARDIZED APPROACH RISK WEIGHTS—Continued

Minimum capital ratios	Proposed treatment
Equity exposures (§§ 628.51, 628.52, and 628.53)	Establishes a more risk-sensitive treatment for equity exposures.
Disclosure Requirements (§§ 628.61, 628.62, and 628.63)	Establishes qualitative and quantitative disclosure requirements, including regarding regulatory capital instruments, for all System banks.
Existing FCA Regulatory Capital	
Minimum Capital Ratios:	
Permanent capital ratio (§§ 615.5201 and 615.5205)	Numerator calculation remains unchanged, but risk weights (denominator) are revised as described in this proposal.
Total surplus ratio (§§ 615.5301(i) and 615.5330(a))	Eliminated.
Core surplus ratio (§§ 615.5301(b) and 615.5330(b))	Eliminated.
Net collateral Ratio (banks only) (§§ 615.5301(d) and 615.5335)	Eliminated.

E. The History and Cooperative Structure of the Farm Credit System

The System is a federally chartered network of four banks and 78 associations that are borrower-owned lending cooperatives, as well as their related service organizations.⁸ Cooperatives are organizations that are owned and controlled by their members who use the cooperatives' products or services. The mission of the System is to provide sound and dependable credit to its member borrowers, who are American farmers, ranchers, producers or harvesters of aquatic products, their cooperatives, and certain farm-related businesses and rural utility cooperatives. The System was created by Congress in 1916 as a farm real estate lender and was the first GSE; in subsequent years, Congress expanded the System to include production credit, cooperative, rural housing, and other types of lending. The System's enabling statute is the Farm Credit Act.⁹

System associations are direct retail lenders; Farm Credit Banks (FCBs) are primarily wholesale lenders to the associations, and the agricultural credit bank (CoBank or ACB) makes retail loans to cooperatives as well as wholesale loans to affiliated associations. Each System bank has a district, or lending territory, which includes the territories of the affiliated associations that it funds; CoBank, in addition, lends to cooperatives nationwide. There are generally two types of associations: Agricultural credit associations (ACAs) and Federal land

credit associations (FLCAs). In general, ACAs make short, intermediate, and long-term operating loans, real estate mortgage loans, and rural housing loans.¹⁰ FLCAs make only long-term real estate mortgage and rural housing loans.

The System banks own the Federal Farm Credit Banks Funding Corporation (Funding Corporation), which is the fiscal agent for the banks and is responsible for issuing and marketing System-wide debt securities in domestic and global capital markets. The banks use the proceeds from the securities to fund their lending and other operations, and the banks are jointly and severally liable on the debt.

The FCA is the System's independent Federal regulator that examines and regulates System institutions for safety and soundness and mission compliance. The Farm Credit System Insurance Corporation (FCSIC) is an independent, U.S. Government-controlled corporation whose purpose is to ensure the timely payment of principal and interest on insured System-wide debt obligations issued on behalf of the System banks. The members of the FCA Board also serve as the members of the FCSIC Board. The FCSIC administers a \$3.5 billion Insurance Fund and collects insurance premiums from System banks.

1. Capital Structure of System Institutions

A System institution's cooperative capital consists of member-borrower

stock, allocated equities, and unallocated retained earnings. System institutions, like all businesses, need capital to absorb losses in times of financial adversity and provide a source of funds to stabilize earnings and finance growth. Capital also carries ownership rights of members, which reflect the System's cooperative nature. Members, both past and current, helped build almost all the capital of System institutions.¹¹

Member stock and allocated equities are the common equity classes of System institutions. As discussed above, this proposed rule refers to member stock and allocated equity collectively as "common cooperative equity." After the URE of an institution is depleted, all categories of common cooperative equities are subject to impairment before preferred stock and other non-cooperative equities of the institution are impaired. This impairment of common cooperative equities by category differs somewhat from the common stock of a joint-stock bank, whose common equities are all impaired on a pro rata basis. However, the FCA considers the impairment by category to be substantially the same, as the common cooperative equities protect other equities and obligations of the institution to the same extent common equities of a joint-stock bank protect non-common equities and obligations.

Table 2 compares the capital of System institutions, as cooperatives, and joint-stock companies.

⁸ This is the System's structure as of December 31, 2013. The Federal Agricultural Mortgage Corporation (Farmer Mac), which is a federally chartered instrumentality, is also an institution in the System. The FCA has a separate set of capital regulations that apply to Farmer Mac, and this

proposed rule does not pertain to Farmer Mac's regulations.

⁹ 12 U.S.C. 2001–2279cc. The Act is available at www.fca.gov under "FCA Handbook."

¹⁰ ACAs may have a production credit association subsidiary that makes short and intermediate-term

loans and a FLCA subsidiary that makes long-term loans.

¹¹ A small amount of regulatory capital comes from the purchase by third-party investors of preferred stock and qualifying subordinated debt.

TABLE 2—CAPITAL INSTRUMENT COMPARISON

	System institution	Joint-stock company
Capital Stock	Preferred Stock (outside investors)	Preferred Stock (member investors)
	Preferred Stock (member investors).	
	Member-Borrower Stock and Participation Certificates	Common Stock.
	Allocated Stock ¹ .	
Earned Net Worth	Allocated Surplus ¹	Retained Earnings.
	Unallocated Retained Equity and URE equivalents.	

¹ Allocated equities include both stock and surplus. System banks generally allocate equity as stock, and System associations generally allocate equity as surplus. Allocated equities in this context may be redeemed at the discretion of the institution.

2. Member Stock—Association Level

A retail borrower of a System association or of the ACB is required to purchase voting stock or non-voting participation certificates (depending on the status of the borrower¹²) as a condition of obtaining a loan¹³ and becoming a member of the institution. For purposes of this discussion, the FCA uses the term “member stock” to refer to both voting stock and participation certificates.

Member stock is redeemable at book value, not to exceed par, only at the discretion of the association’s board of directors and subject to the association’s compliance with capital adequacy requirements. When these requirements are met, associations routinely retire member stock within some timeframe after the member has repaid the loan. System associations are authorized to pay dividends on member stock but do not currently do so.

Currently, all associations set their member stock purchase requirements at the Farm Credit Act’s minimum of the lesser of \$1,000 or 2 percent of the loan amount,¹⁴ regardless of the member’s loan volume. Thus, while association stock purchased by borrowers embodies a key cooperative principle, it is not a significant source of association capital.

3. Member Stock—System Bank Level

By contrast, member stock purchased by associations in their affiliated System bank plays an important role in capitalizing System banks. Each System bank sets a “required investment” for its affiliated associations based on a percentage of each association’s loan

¹² Only members engaged in agriculture and aquaculture may hold voting stock in associations. Except for the ACB, only System associations may hold voting stock in their affiliated bank. The ACB’s voting members are its affiliated associations as well as its agricultural and rural utility cooperative borrowers. Other borrowers, such as rural homeowners who are not farmers and other financing institutions, buy participation certificates as a condition of getting a loan or service.

¹³ A member may also purchase preferred stock as an investment in the association if the association offers such stock. Such preferred stock is not a common cooperative equity.

¹⁴ Section 4.3A(c)(1)(E)(i) of the Act.

volume funded by the bank. System bank advances fund the stock purchases, and the associations’ repayments of these advances reduce their retained earnings.¹⁵ As an association’s loan volume grows, the bank requires the association periodically to acquire additional stock to maintain the required stock investment. When an association’s loan volume decreases, the bank either pays a return on what the bank deems “excess” stock through an interest credit or an increased patronage refund distribution, or the bank retires such stock. Tying the amount of the required investment to the amount of the loan results in each association’s bearing the cost and risks of bank capital relative to the association’s share of bank debt, but this practice also makes the stock less permanent because the bank routinely issues or redeems the stock.

The ACB’s capitalization program sets a “targeted investment” for its members based on loan volume and allows its members to accumulate the targeted investment through the bank’s payment of stock patronage refunds, or to purchase stock to fulfill the entire investment requirement. The ACB’s affiliated associations have all chosen to meet the target through stock purchases rather than through accumulations of allocated equities.

4. Allocated Equities

As discussed above, some System institutions provide cooperative benefits to their borrowers by paying patronage refunds to their member borrowers based on net income. Patronage refunds may be paid in cash or allocated equities¹⁶ (stock or surplus) or a combination of both. When institutions pay patronage refunds as allocated equity, they actually retain the allocated equity thus effectively increasing a

¹⁵ System banks and associations’ accounting systems and wire transfer systems are highly coordinated if not the same within districts; therefore, a reduction in retained earnings would be equivalent to cash repayment of an advance.

¹⁶ The FCA uses the term “allocated equity” to mean patronage refunds retained as both allocated stock and allocated surplus.

borrower’s equity investment in the institution. For tax purposes, a System institution that declares a patronage refund must provide the borrower with a written notice of allocation evidencing the amount paid in cash and the amount of allocated equity.¹⁷ In this context, FCA is describing allocated equities that the institution determines are subject to redemption. Those allocated equities that an institution determines are not subject to redemption will be discussed later.

Allocated equities have certain rights and features in common with member stock. Allocated equities are redeemable at book value, not to exceed face value, only at a board’s discretion and subject to compliance with regulatory and supervisory capital requirements.

5. Unallocated Retained Earnings (URE) and URE Equivalents

URE consists of current and retained earnings not allocated to a member or distributed through patronage refunds or dividends.¹⁸ It is free from any specific ownership claim or expectation of allocation, and it absorbs losses before other forms of surplus and stock. For the past two decades, System associations have retained their earnings primarily in the form of URE. One distinction between URE and allocated equity is whether the institution provides a written notice of allocation to the borrower. If the System institution does not provide a written notice of allocation to the borrower, the equity is URE. However, many System institutions keep “memo” records so that URE may be attributed to a borrower if liquidation occurs.¹⁹

In a liquidation, current and past members may have a fixed and limited

¹⁷ Under Subchapter T of the Internal Revenue Code, there are two types of allocated equities: Qualified and nonqualified. Their Federal income Tax treatment differs. See 26 U.S.C. 1381–1388.

¹⁸ Under GAAP, a System institution may include allocated equity not subject to retirement in its URE.

¹⁹ A limited amount of System URE stems from non-patronage sources and, under the bylaws of most System institutions, would be distributed at liquidation among past and present patrons.

claim on URE (except allocated equity not subject to retirement that is treated as URE under generally accepted accounting principles (GAAP)).

The FCA has considered certain nonqualified allocated equities to be the equivalent of URE when a System institution has provided a written notice of allocation to members stating the equities are not subject to redemption except upon liquidation or dissolution. To treat these nonqualified allocated equities as URE in the core surplus ratio, the FCA has required System institutions to adopt bylaw provisions that the nonqualified allocated equity cannot be:

- Redeemed other than in a liquidation or dissolution of the institution;
- Considered by the institution as satisfying any borrower requirement to capitalize the entity; and
- Offset against the specified borrower's loan in the event of a loan loss on the specified borrower's account.

F. The FCA's Current Capital Regulations

The FCA currently has three risk-based minimum capital standards: (1) A 3.5-percent core surplus ratio (CSR); (2) a 7-percent total surplus ratio (TSR); and (3) a 7-percent permanent capital ratio (PCR).²⁰ Congress added a definition of "permanent capital" to the Farm Credit Act in 1988 and required the FCA to adopt risk-based permanent capital standards for System institutions. The FCA adopted permanent capital regulations in 1988 and, in 1997, added core surplus and total surplus capital standards for banks and associations, as well as a non-risk-based net collateral ratio (NCR) for banks.²¹ Since then, we have made only minor changes to these regulations.

Permanent capital is defined in the Farm Credit Act to include current earnings, unallocated and allocated earnings,²² stock (other than stock retireable on repayment of the holder's loan or at the discretion of the holder, and certain stock issued before October 1988), surplus less allowance for loan losses (ALL), and other debt or equity instruments that the FCA determines appropriate to be considered permanent capital. Allocated equities shared by a

bank and each affiliated association—that is, equities that a bank has allocated to an affiliated association—appear on the books of both institutions but can be counted in only one institution's permanent capital pursuant to a capital allotment agreement between the two institutions.

Core surplus is high-quality capital similar (but not identical) to Basel I's tier 1 capital and generally consists of URE, certain allocated surplus, and noncumulative perpetual preferred stock. In calculating core surplus, an association must deduct its net investment in its affiliated bank; the bank may not include in its core surplus the equities it has issued or distributed to its affiliated associations. At least 1.5 percent of the minimum 3.5-percent core surplus requirement must consist of URE and noncumulative perpetual preferred stock. We did not include equities held by one System institution in another institution because we wanted institutions to have sufficient high-quality capital on a standalone basis in the event the other System institution became severely weakened.

Total surplus generally contains most of the components of permanent capital but excludes stock held by members as a condition of obtaining a loan and certain other instruments that are routinely and frequently retired by institutions.

G. Prior FCA Advance Notices of Proposed Rulemaking (ANPRMs) on the Basel Capital Standards

In October 2007, the FCA published an advance notice of proposed rulemaking (ANPRM) on the risk weighting of assets—the denominator in our risk-based core surplus, total surplus, and permanent capital ratios—a possible leverage ratio, and a possible early intervention framework.²³ A comment letter we received in December 2008 from the Funding Corporation on behalf of the System focused primarily on the numerators of those regulatory capital ratios.²⁴ The System urged us to replace the core surplus and total surplus capital standards with a "Tier 1/Tier 2" capital framework consistent with the Basel Accord (Basel I and Basel II) and the other Federal banking regulatory agencies' guidelines. The comment letter stated that, "because the System's growth has required the use of external equity capital, the System is in regular contact with the financial community,

including rating agencies and investors. Obtaining capital at competitive terms, conditions, and rates requires these parties [to] understand the System's and individual institution's financial position, making consistency with approaches used by other regulators, rating agencies, and investment firms a requirement to enhance the capacity of the System to achieve its mission. For the System to achieve its mission, the System must be able to compete with other lenders. Therefore, FCA's capital regulations must result in a regulatory framework that provides for a level playing field, in addition to safe and sound operations." Furthermore, the System recommended that we replace our NCR, which is applicable only to banks, with a non-risk-based leverage ratio applicable to all System institutions.

In December 2009, the Basel Committee published a consultative document that proposed fundamental reforms to the current tier 1/tier 2 capital framework.²⁵ The Basel Committee's primary aims were to improve the banking sector's ability to absorb shocks arising from financial and economic stress, to mitigate spillover risk from the financial sector to the broader economy, and to increase bank transparency and disclosures. The FCA issued another ANPRM in July 2010 seeking comments on a tier 1/tier 2 regulatory capital structure that would be similar to the capital tiers delineated in the Basel consultative document and the then-existing guidelines of the Federal regulatory banking agencies. We received two comment letters, one from a System institution and one from a trade association on behalf of the System. Both commenters strongly supported the FCA's adoption of a capital framework that was as similar as possible to the capital guidelines of the Federal regulatory banking agencies as revised to implement the Basel III standards. In particular, they asserted that consistency of FCA capital requirements with those of the Federal regulatory banking agencies and transparency would allow investors, shareholders, and others to better understand the financial strength and risk-bearing capacity of the System. The FCA decided to delay issuing a proposed rule until the Basel Committee had issued its new framework and the Federal regulatory banking agencies had

²⁰ See 12 CFR 615.5201–615.5216 and 615.5301–615.5336.

²¹ See 53 FR 39229 (October 6, 1988) and 63 FR 39229 (July 22, 1998).

²² In this preamble, "unallocated and allocated earnings" would be equivalent to "unallocated retained earnings and allocated equities". Additionally "surplus" would be "unallocated retained earnings".

²³ 72 FR 61568 (October 31, 2007).

²⁴ Comment letter dated December 19, 2008, from Jamie Stewart, President and CEO, Funding Corporation, on behalf of the System.

²⁵ "Basel Consultative Proposals to Strengthen the Resilience of the Banking Sector," December 17, 2009. The document is available at <http://www.bis.org/publ/bcbs164.htm>.

proposed rules to implement that framework.

After soliciting comments on its December 2009 consultative document, the Basel Committee issued the new Basel III capital standards in December 2010 (revised June 2011). In 2012, the Federal regulatory banking agencies issued proposed rules to implement those standards and adopted final rules in October 2013 and April 2014.

The FCA agrees generally with the System's position that a tier 1 and tier 2 regulatory capital framework comparable to Basel III and the Federal regulatory banking agencies' new rules would be beneficial to System institutions, their members, the investment community, and other interested parties. It would also facilitate the issuance of equities and subordinated debt to third-party investors. In addition, we believe it necessary and appropriate to update the denominator risk weightings that have been revised based on the lessons learned in the 2008 global financial crisis.

When we adopted the core surplus, total surplus and the net collateral ratios in 1997, transparency to the investment community was not a significant consideration because the capital in the System institutions was held by or generated by their members. The goal of those regulations was to ensure that each System institution built sufficient high-quality capital, especially URE and URE equivalents, to serve the needs of all qualifying eligible borrowers and to withstand downturns in the agricultural sector as well as adversities at other System institutions. The FCA continues to believe a significant amount of URE and URE equivalents is necessary to achieve and maintain that goal but also believes common cooperative equities may be included in the higher quality capital measures to a larger extent than they are included in our current regulations. This position is based on a number of factors, including the reduction of the member stock requirement at most institutions to the statutory minimum and the institutions' evolving allocated equity redemption practices.

Through the 1990s and to the present day, a strong agricultural economy together with sound business practices has enabled System institutions to build higher quality capital while at the same time growing the System's total assets from \$64.8 billion in 1993 to \$260.8 billion at the end of 2013.

II. Minimum Regulatory Capital Ratios, Additional Capital Requirements, and Overall Capital Adequacy

A. Minimum Risk-Based Capital Ratios and Other Regulatory Capital Provisions

The FCA is proposing the following minimum capital ratios: (1) A common cooperative equity tier 1 (CET1) capital ratio of 4.5 percent; (2) a tier 1 capital ratio of 6 percent; (3) a total capital ratio of 8 percent; and (4) a tier 1 capital leverage ratio of 5 percent, of which at least 1.5 percent must be composed of URE and URE equivalents. Tier 1 capital would equal the sum of CET1 and AT1 capital. Total capital would consist of CET1, AT1, and tier 2 capital. As noted above, the FCA's existing core surplus, total surplus, and net collateral requirements would be rescinded, but the minimum permanent capital requirements would be retained.

In addition, each System institution would be subject to a capital conservation buffer in excess of the risk-based capital requirements that would impose limitations on its capital distributions and certain discretionary bonuses, as described in section C below. The capital conservation buffer would not be considered a minimum capital requirement.

The FCA will continue to hold each System institution accountable to maintain sufficient capital commensurate with the level and nature of the risks to which it is exposed. This may require capital significantly above the minimum requirements, depending on the institution's activities and risk profile. Section D below describes the requirement for overall capital adequacy of System institutions and the supervisory assessment of an institution's capital adequacy.

Consistent with the FCA's authority under the Farm Credit Act and current capital regulations, proposed § 628.10(d) confirms FCA's authority to require an institution to hold a different amount of regulatory capital from what would otherwise be required under the proposal, if we determine that the institution's regulatory capital is not commensurate with its credit, operational, or other risks.

B. Leverage Ratio

The FCA is proposing a tier 1 leverage ratio for all System institutions of 5 percent, of which at least 1.5 percent of non-risk-weighted total assets must be URE and URE equivalents. This would replace the net collateral ratio requirement for System banks. System associations do not currently have a leverage ratio requirement. The proposed ratio differs from the Federal

regulatory banking agencies' leverage ratio in two respects: There is no minimum URE and URE equivalents requirement in their leverage ratio, and their minimum requirement is 4 percent.

A leverage ratio constrains the build-up of leverage in the System, which the risk-based regime is not designed to do. It reinforces the risk-based requirements with a non-risk-based backstop—that is, if the computation of the risk-weighted assets does not accurately reflect the true underlying risk inherent in a System institution, the leverage ratio serves as a floor that prevents the institution from decreasing its capital below a certain percentage of total assets. Furthermore, it represents a standardized measure that can be used to make comparison among System institutions over time.

The 5-percent leverage ratio takes into consideration the fact that System institutions are financially and operationally interconnected, member-owned cooperatives, and monoline lenders that currently provide credit to approximately 41 percent of the United States agriculture sector. They have a business model and risk profile that are substantially different from traditional banking organizations.

The higher 5-percent leverage ratio also helps to ensure that System institutions continue to have sufficient systemic loss-absorbing capital to withstand a severely adverse economic event while continuing to provide a steady flow of credit to U.S. agriculture in view of the System's unique GSE mission.

For associations, the proposed 5-percent minimum leverage ratio would differ little from their proposed tier 1 risk-based capital requirement. Most associations' on-balance sheet assets are risk weighted at 100 percent, and the associations do not have significant off-balance sheet items. This is not the case for System banks, however. While System banks do have off-balance sheet items that would have to be risk weighted—especially unfunded commitments in this proposal—the banks also have a large portion of instruments in the 20-percent risk-weighting category, primarily the direct loans to their affiliated associations, and the 0-percent risk-weighting category. We believe it is important for System banks to hold enough capital to protect against risks other than credit risk (*e.g.* interest rate risk, liquidity risk, premium risk, operational risk, etc.).

The 1.5-percent minimum URE and URE equivalents requirement is similar in some respects to our current requirement that at least 1.5 percent of

an institution's core surplus must consist of URE and URE equivalents and noncumulative perpetual preferred stock. For associations, the great majority of which have not issued noncumulative perpetual preferred stock, compliance with the proposed 1.5-percent URE and URE equivalents requirement would differ little from the compliance with their existing 1.5 percent of core surplus requirement. By contrast, all banks have noncumulative perpetual preferred stock outstanding that is included in their 1.5-percent core surplus requirement but would not be included in the proposed 1.5-percent URE and URE equivalents minimum standard. The FCA believes that it is especially important for System banks to hold sufficient URE and URE equivalents to cushion the third-party and common cooperative equities that make up the rest of tier 1 capital. URE and URE equivalents, when depleted, do not result in losses to a System's institution's members. URE protects against the interconnected risk that exists between System banks and associations; it protects association members against association losses, associations against bank losses, and the System against financial contagion. We are proposing to make the URE and URE equivalents a part of the leverage ratio because a URE minimum tied to risk-adjusted assets may not be sufficient for the banks, which have a greater disparity between risk-adjusted assets and total assets.

C. Capital Conservation Buffer

Consistent with Basel III and the Federal regulatory banking agencies' rules, we are proposing a capital conservation buffer to enhance the resilience of System institutions throughout financial cycles. To avoid restrictions on cash payments for patronage, redemptions, and dividends (collectively, capital distributions) or discretionary executive bonuses, an institution's risk-weighted regulatory capital ratios would have to be at least 2.5 percent above the minimums when the buffer is fully phased in. The buffer would provide an incentive for institutions to hold capital well above the minimum required levels to ensure that they would meet the regulatory minimums even during stressful conditions.

The capital conservation buffer would consist of tier 1 capital and would be the lowest of the following risk-weighted measures:

- The institution's CET1 ratio minus its minimum CET1 ratio;
- The institution's tier 1 ratio minus its minimum tier 1 ratio; and

- The institution's total capital ratio minus its minimum total capital ratio. If any of the institution's risk-weighted ratios were at or below the minimum required ratios, the institution's capital conservation buffer would be zero.

The maximum payout ratio would be the percentage of eligible retained income that a System institution would be allowed to pay out in capital distributions and discretionary bonuses during the current calendar quarter and would be determined by the amount of the capital conservation buffer held by the institution during the previous calendar quarter. Eligible retained income would be defined as the institution's net income as reported in its quarterly call reports to the FCA for the four calendar quarters preceding the current calendar quarter, net of any capital distributions, certain discretionary bonus payments, and associated tax effects not already reflected in net income.

A System institution's maximum payout amount for the current calendar quarter would be equal to its eligible retained income multiplied by the applicable maximum payout ratio in accordance with table 1 in § 628.11. An institution with a capital conservation buffer that is greater than 2.5 percent would not be subject to a maximum payout amount under this provision (although distributions without FCA prior approval may be restricted by other provisions in this proposed rule). If an institution's CET1, tier 1, or total capital ratio is 2.5 percent or less above the minimum ratio, the maximum payout ratio would also decline. The institution would remain subject to payout restrictions until it raises its capital conservation buffer above 2.5 percent. In addition, a System institution would not generally be able to make capital distributions or pay discretionary bonuses during the current calendar quarter if its eligible retained income is negative and its capital conservation buffer is less than 2.5 percent as of the end of the previous quarter.

The capital conservation buffer is divided into quartiles, with greater restrictions on capital distributions and discretionary bonus payments as the capital conservation buffer falls closer to 0 percent. When the buffer is fully phased in, payouts would be restricted to 60 percent of eligible retained income if the buffer is above 1.875 percent but at or below 2.5 percent. When the buffer is above 1.25 percent but less than or equal to 1.875 percent, the payout would be restricted to 40 percent of eligible retained income. When the

buffer is above 0.625 percent but equal to or below 1.25 percent, the payout would be restricted to 20 percent of eligible retained income. A capital conservation buffer of 0.625 percent or below would result in a 0-percent payout.

The FCA proposes to define a capital distribution as:

- A reduction of tier 1 capital through the repurchase or redemption of a tier 1 capital instrument or by other means, unless the redeemed capital is replaced in the same quarter by tier 1 qualifying capital;
- A reduction of tier 2 capital through the repurchase, or redemption prior to maturity, of a tier 2 capital instrument or by other means, unless the redeemed capital is replaced in the same quarter by qualifying tier 1 or tier 2 capital;
- A dividend declaration or payment on any tier 1 capital instrument;
- A dividend declaration or interest payment on any tier 2 capital instrument if the institution has full discretion to suspend such payments permanently or temporarily without triggering an event of default;
- A cash patronage refund declaration or payment;
- A patronage refund declaration in the form of allocated equities that do not qualify as tier 1 or tier 2 capital;²⁶ or
- Any similar transaction that the FCA determines to be in substance a distribution of capital.²⁷

The FCA proposes to define a discretionary bonus payment as a payment made to a senior officer of a System institution, where:

- The System institution retains discretion whether to pay the bonus and how much to pay until it awards the payment to the senior officer;
- The System institution determines the amount of the bonus without prior promise to, or agreement with, the senior officer; and
- The senior officer has no express or implied contractual right to the bonus payment.

The term "senior officer" is already defined in § 619.9310 as "[t]he Chief Executive Officer, the Chief Operations Officer, the Chief Financial Officer, and the General Counsel, or persons in

²⁶ A patronage refund declaration or payment in the form of allocated equities that qualify as tier 1 capital is not a reduction in tier 1 capital. It is merely a reclassification from one tier 1 capital element into a different tier 1 capital element.

²⁷ We note that the Federal regulatory banking agencies replaced the term "capital distribution" with "distribution" in their final rule. We have decided to use the term "capital distribution" to avoid potential confusion with other types of distributions that do not meet the definition for purposes of applying the capital conservation buffer.

similar positions; and any other person responsible for a major policy-making function.”²⁸

The purpose of limiting restrictions on discretionary bonus payments to senior officers is to focus these measures on the individuals within an institution who could expose the institution to the greatest risk. We note that the institution may otherwise be subject to limitations on capital distributions under other provisions in this rule. In addition, we retain authority to approve a capital distribution or bonus payment if we determine that the payment would not be contrary to the purposes of the capital conservation buffer or the safety and soundness of the institution.

D. Supervisory Assessment of Overall Capital Adequacy

System institutions should have internal processes to assess capital adequacy that reflect a full understanding of risks and to ensure sufficient capital is held. Our supervisory assessment of capital adequacy must take account of the internal processes for capital adequacy, as well as risks and other factors that can affect an institution's financial condition, including the level and severity of problem assets and total surplus exposure to operational and interest rate risk. For this reason, a supervisory assessment of capital adequacy may differ significantly from conclusions that might be drawn solely from the level of the institution's risk-based capital ratios.

The FCA expects System institutions generally to operate with capital levels well above the minimum risk-based ratios and to hold capital commensurate with the level and nature of the exposed risk. For example, System institutions that are growing or that anticipate growth in the near future should maintain strong capital levels substantially above the minimums and should not allow significant diminution of financial strength below such levels to fund their growth. System institutions with high levels of risk are also expected to operate with capital well above the minimum levels. The supervisory assessment also evaluates the quality and trends in an institution's capital composition, including the share of common cooperative equities and URE and equivalents.

Section 628.10(d) of the proposal would maintain and reinforce these supervisory expectations by requiring

that a System institution maintain capital commensurate with the level and nature of all risks to which it is exposed and that the institution have a process for assessing its overall capital adequacy in relation to its risk profile, as well as a comprehensive strategy for maintaining an appropriate level of capital.

The supervisory assessment may include such factors as whether the institution has merged recently, entered new activities, or introduced new products. It would also consider whether an institution is receiving special supervisory attention from FCA, has or is expected to have losses resulting in capital inadequacy, has significant exposure due to risks from concentrations in credit or nontraditional activities, or has significant exposure to interest rate risk, operational risk, or could be adversely affected by the activities or condition of an affiliated System institution.

The supervisory assessment would also evaluate the comprehensiveness and effectiveness of a System institution's capital as required by §§ 615.5200 and 618.8440 of existing FCA regulations. We are proposing to revise § 615.5200 to require the planning to include the new ratios in this proposed rule. An effective capital planning process would require a System institution to assess its risk exposures, develop strategies for mitigating those risks, and set capital adequacy goals relative to its risks, and prospective economic conditions. Evaluation of an institution's capital adequacy process would be commensurate with the institution's size, sophistication, and risk profile.

III. Definition of Capital

A. Capital Components and Eligibility Criteria for Regulatory Capital Instruments

1. Common Cooperative Equity Tier 1 (CET1) Capital

Under the proposed rule, a System institution's CET1 would be the sum of URE and common cooperative equities, minus the regulatory adjustments and deductions described in § 628.22. We have adapted the criteria for the common cooperative equities in accordance with footnote 12 of Basel III, which states that the criteria for non-joint stock companies, including mutuals and cooperatives, should take into account their legal structure and constitution.²⁹ The footnote provides

that the CET1 criteria “should preserve the quality of the instruments by requiring that they are deemed fully equivalent to common shares . . . as regards loss absorption and do not possess features which could cause the condition of the [non-joint stock] bank to be weakened as a going concern during periods of market stress.” The Federal regulatory banking agencies' rules have decided to apply the same criteria to the mutual financial institutions they regulate and to their joint-stock banking organizations.

Basel III established 14 criteria a banking organization must meet to include an instrument in CET1 capital; the Federal regulatory banking agencies' rules have 13 criteria. These criteria are intended to ensure that the instrument will be available to absorb losses at the banking organization on a going-concern basis. Several of the criteria provide that the instrument must represent the most subordinated claim in liquidation, is entitled to a claim on residual assets proportional to its share of issued capital, and must take the first and proportionately greatest share of any losses as they occur.

Unlike joint-stock banks, System institutions have priorities of impairment among the various classes of member stock and allocated equities, and typically all current and former members are entitled to the residual assets, based on historic patronage, in a liquidation of the institution. However, all common cooperative equities are impaired and depleted before all other instruments. Therefore, we are replacing these criteria with criteria providing that the instrument must represent a claim subordinated to all other equities of an institution in a liquidation, and the holder receives payment only after all general creditors and debt holders are paid.

Another CET1 criterion of Basel III and the Federal regulatory banking agencies is that the banking organization does nothing to create an expectation at issuance that the instrument will be redeemed, nor do the statutory or contractual terms provide any feature that might give rise to such an expectation. In the System, institutions issue or distribute some common cooperative equities that are never retired and that do not give rise to redemption expectations by members. Other common cooperative equities, by contrast, are routinely and frequently redeemed. Through this practice, System institutions can create expectations on the part of their members that these purchased and allocated equities will be redeemed. Consequently, we believe that the

²⁸ The FCA considers this definition substantively identical to the definition of “executive officer” used in the Federal regulatory banking agencies' rules on the capital conservation buffer.

²⁹ Basel III framework footnote 12 to “Criteria for classification as common shares for regulatory capital purposes”.

“expectation” requirement of Basel III and the Federal regulatory banking agencies’ rules could reasonably be interpreted to disallow common cooperative equities redeemed by System institutions from CET1. However, it is important for the current members of a cooperative to provide capital to the cooperative and for current and former members of the cooperative eventually to receive a return of their capital. Therefore, we have decided to recognize this key cooperative principle by including in CET1 purchased and allocated equities that meet the requirements described below.

The FCA is proposing to include in CET1 an amount of member stock equal to the minimum stock purchase requirement set forth in the Farm Credit Act. That minimum amount is the lesser of \$1,000 or 2 percent of the member’s loan or loans. The FCA has reviewed the 2013 regulatory technical standards of the European Banking Authority (EBA) regarding the standards for CET1 for cooperatives, mutuals, the other non-joint stock banks.³⁰ European cooperative banks do not issue allocated equities; therefore, the technical regulations have little application to the treatment of System institutions’ allocated equities. However, we have adapted the EBA document’s treatment of minimum required amounts of purchased cooperative equities to allow System institutions to include purchased member stock in their CET1.

Purchased member capital is routinely funded directly or indirectly by European cooperative banks, and the same is true for System institutions. The CET1 criteria for Basel III and the Federal regulatory banking agencies’ rules do not permit joint-stock banks to include in CET1 any equities whose purchase is directly or indirectly funded by the bank. However, the EBA document permits cooperatives to include directly or indirectly funded member stock (called a subscription) if the amount of the subscription is not material, the purpose of the cooperative’s loan to the member is not the purchase of an institution’s capital instrument, and the member stock purchase is necessary in order for the beneficiary of the loan to become a member of the cooperative. The required minimum stock purchase requirements in System institutions mirror these characteristics.

Some countries in the European Union require the redemption of the member’s subscription when the member pays off the loan. That is not the case with respect to System institutions. They may, but are not required to, redeem the member’s required stock when a loan is paid. As a general matter, the FCA has not given favorable treatment to member stock in its capital regulations because of the widespread and routine redemptions of member stock when the member’s loan is paid off. Notwithstanding these concerns, because the repayment of the member’s loan reduces the level of assets that the System institution must capitalize and because of the similar characteristics with EBA provisions, we have determined that including an amount equal to the minimum stock purchase requirement appropriately recognizes the cooperative structure of the System and is acceptable from a safety and soundness standpoint. For this minimum amount of stock, the institution would not have to obtain the prior approval of the FCA before redeeming it and would not be required to keep it outstanding for a minimum period. In other words, the institution could redeem the member’s minimum required stock according to its current redemption practices.

The FCA is also proposing to include other member-purchased common cooperative equities and allocated equities of System institutions that adopt a capitalization bylaw providing that the institution will not redeem the equities for at least 10 years (for CET1 capital) and for at least 5 years (for tier 2 capital) after issuance or distribution, will not offset such equities against a member’s loan in default, and will not redeem the equities without the FCA’s prior approval unless the redemption falls within the “safe harbor” provision described below.

System institutions typically have allocated equity revolvment periods ranging from 4 to 10 years, and perhaps longer, for their allocated equities. We believe allocated equities with shorter revolvment periods have higher member expectations of redemption than allocated equities that are held longer. Such expectations may put stress on System institutions to continue to redeem equities even when the institution’s financial health is deteriorating. Institutions’ boards of directors generally prefer to revolve allocated equities on a regular basis. This aids in the capital planning process and can help manage the revolvment expectations of the members. While the regularity of redemptions results in a rise in member expectations, we believe

a longer revolvment period has the effect of moderating these expectations—that is, if a member is not expecting equities allocated in 2015 to be redeemed before 2025, the member is less likely to count on the cash redemption of those equities in the member’s own capital planning. Therefore, we are retaining an “expectation” criterion similar to that in Basel III and the Federal regulatory banking agencies’ rules, but we are providing that equities held by an institution for at least 10 years will not be considered to create an expectation. Cash payment of patronage refunds, dividends, and redemption of allocated equities normally are paid from current year net income, and an institution must ensure it generates sufficient net income to cover these expected cash outlays from capital. A shorter revolvment or redemption cycle places more strain than a longer revolvment or redemption cycle on an institution’s ability to generate a return to stockholders and capitalize growth.

Under this proposal, all System institutions would be able to include an amount equal to the minimum stock purchase requirements of their members in CET1 capital, as well as purchased stock or allocated equities that the institution never retires. System institutions that have a member stock purchase requirement that is higher than the statutory minimum and that revolve allocated equities would be able to include all such equities in CET1 capital if they ensure that the purchased stock and allocated equities are not redeemed for at least 10 years. Member stock in excess of the statutory minimum and allocated equities that are retained for at least 5 years are includable in tier 2 capital; if retained for less than 5 years, such equities are not includable in tier 1 or tier 2.

a. Criteria

The FCA proposes to require that the common cooperative equities included in CET1 satisfy all the following criteria:

(1) The instrument is issued directly by the System institution and represents a claim subordinated to all preferred stock, all subordinated debt, and all liabilities in a receivership, insolvency, liquidation, or similar proceeding of the System institution;

(2) If the holder of the instrument is entitled to a claim on the residual assets of the System institution, the claim will be paid only after all general creditors, subordinated debt holders, and preferred stock claims have been satisfied in a receivership, insolvency, liquidation, or similar proceeding;

³⁰ European Banking Authority, EBA Final Draft Regulatory Technical Standards on Own Funds [Part 1] Under Regulation (EU) No. 575/2013 Capital Requirements Regulation—CRR), Title II, ch. 1, art. 7.

(3) The instrument has no maturity date, can be redeemed only at the discretion of the System institution and with the prior approval of FCA, and does not contain any term or feature that creates an incentive to redeem;

(4) The System institution did not create, through any action or communication, an expectation that it will buy back, cancel, revolve, or redeem the instrument, and the instrument does not include any term or feature that might give rise to such an expectation, except that the establishment of a revolving period of 10 years or more, or the practice of revolving or redeeming the instrument no less than 10 years after issuance or allocation, will not be considered to create such an expectation;

(5) Any cash dividend payments on the instrument are paid out of the System institution's net income or unallocated retained earnings, and are not subject to a limit imposed by the contractual terms governing the instrument;

(6) The System institution has full discretion at all times to refrain from paying any dividends without triggering an event of default, a requirement to make a payment-in-kind, or an imposition of any other restrictions on the System institution;

(7) Dividend payments and other distributions related to the instrument may be paid only after all legal and contractual obligations of the System institution have been satisfied, including payments due on more senior claims;

(8) The holders of the instrument bear losses as they occur before any losses are borne by holders of preferred stock claims on the System institution and holders of any other claims with priority over common cooperative equity instruments in a receivership, insolvency, liquidation, or similar proceeding;

(9) The instrument is classified as equity under GAAP;

(10) The System institution, or an entity that the System institution controls, did not purchase or directly or indirectly fund the purchase of the instrument, except that where there is an obligation for a member of the institution to hold an instrument in order to receive a loan or service from the System institution, an amount of that loan equal to the minimum borrower stock requirement under section 4.3A of the Farm Credit Act will not be considered as a direct or indirect funding where:

(a) The purpose of the loan is not the purchase of capital instruments of the

System institution providing the loan; and

(b) The purchase or acquisition of one or more member equities of the institution is necessary in order for the beneficiary of the loan to become a member of the System institution;

(11) The instrument is not secured, not covered by a guarantee of the System institution, and is not subject to any other arrangement that legally or economically enhances the seniority of the instrument;

(12) The instrument is issued in accordance with applicable laws and regulations and with the institution's capitalization bylaws;

(13) The instrument is reported on the System institution's regulatory financial statements separately from other capital instruments; and

(14) The System institution's capitalization bylaws provide that it will not redeem the instrument for a period of at least 10 years after issuance, or if allocated equities at least 10 years after allocation to a member, or reduce the original revolving period to less than 10 years without the prior approval of the FCA, except that the minimum statutory borrower stock described under paragraph (b)(1)(x) of this section may be redeemed without a minimum period outstanding after issuance and without the prior approval of the FCA.

b. Accumulated Other Comprehensive Income (AOCI) and Minority Interests

The FCA is not proposing to include minority interests in CET1 or in any other component of regulatory capital because System institutions have few or no minority equity interests in unconsolidated subsidiaries.

The FCA is not proposing to include AOCI in CET1 capital, which is different from Basel III and the Federal banking regulatory agencies' final rules. As a result, we are proposing no adjustments to CET1 for AOCI.

Under the FCA's current risk-based capital rules, most of the components of AOCI included in GAAP equity are not included in a System institution's regulatory capital. Under GAAP, AOCI includes unrealized gains and losses on certain assets and liabilities that are not included in net income. AOCI includes unrealized gains and losses on available-for-sale (AFS) securities; "other than temporary impairment on securities" reported as held to maturity (HTM) that are not credit related; cumulative gains and losses on cash-flow hedges; foreign currency translation adjustments; and amounts attributed to defined benefit post retirement plans resulting from the initial and subsequent application of the

relevant GAAP standards that pertain to such plans.

The Federal banking regulatory agencies include in CET1 capital any net unrealized losses on AFS equity securities and any foreign currency translation adjustments. System institutions carry all equity investments in other System institutions at par or book value. Current investment regulations restrict equity investment outside the System. Therefore, it would be rare for a System institution to have any net unrealized losses or gains because of AFS equity securities. Only one System institution, CoBank, would have a need to hold foreign currency, and only in an amount to facilitate its lending activities. As a result, the FCA is not proposing to include any AOCI item in CET1 capital, as it does not believe AFS equity securities or foreign currency translation adjustments would ever be material to CET1 capital.

We note that, while the Federal regulatory banking agencies' proposed rule would have required all banking organizations to include most elements of AOCI in CET1 capital, the agencies' final rule permits banking organizations using the standardized approach to make a one-time election not to include most elements of AOCI in their regulatory capital. The preamble to the final rule states that the agencies received a significant number of comments expressing concern about the potential volatility of AOCI inclusion on a banking organization's capital and made other assertions about the negative effect the proposed treatment would have on an organization's ability to manage liquidity and interest rate risk. Under the FCA's proposed AOCI treatment, the exclusion of AOCI from CET1 capital would be comparable to the AOCI exclusions of the banking organizations that make an election not to include AOCI in their CET1 capital.

We seek comment on using alternative terms or conditions that FCA could apply to common cooperative equities. Is a 10-year revolving cycle long enough to reduce the expectation of redemption and increase the permanence of such equity instruments so that they may be included in CET1 capital?

2. Additional Tier 1 (AT1) Capital

The proposed criteria for AT1 are comparable to Basel III and the Federal regulatory banking agencies' rules. AT1 would include primarily noncumulative perpetual preferred stock issued by System institutions and would be subject to certain adjustments and deductions. Qualifying instruments would primarily be stock issued by

System banks to third-party investors, though all System institutions have authority to issue such stock. AT1 would not include common cooperative equities.

a. Criteria

The criteria for inclusion in AT1 capital are:

(1) The instrument is issued and paid-in;

(2) The instrument is subordinated to general creditors and subordinated debt holders of the System institution in a receivership, insolvency, liquidation, or similar proceeding;

(3) The instrument is not secured, not covered by a guarantee of the System institution and not subject to any other arrangement that legally or economically enhances the seniority of the instrument;

(4) The instrument has no maturity date and does not contain a dividend step-up or any other term or feature that creates an incentive to redeem;

(5) If callable by its terms, the instrument may be called by the System institution only after a minimum of 5 years following issuance, except that the terms of the instrument may allow it to be called earlier than 5 years upon the occurrence of a regulatory event that precludes the instrument from being included in AT1 capital, or a tax event. In addition:

(a) The System institution must receive prior approval from FCA to exercise a call option on the instrument.

(b) The System institution does not create at issuance of the instrument, through any action or communication, an expectation that the call option will be exercised.

(c) Prior to exercising the call option, or immediately thereafter, the System institution must either: Replace the instrument to be called with an equal amount of instruments that meet the criteria for a CET1 or AT1 capital instrument;³¹ or demonstrate to the satisfaction of FCA that following redemption, the System institution will continue to hold capital commensurate with its risk;

(6) Redemption or repurchase of the instrument requires prior approval from FCA;

(7) The System institution has full discretion at all times to cancel dividends or other distributions on the instrument without triggering an event of default, a requirement to make a payment-in-kind, or an imposition of other restrictions on the System institution except in relation to any

distributions to holders of common cooperative equity instruments or other instruments that are *pari passu* with the instrument.

(8) Any distributions on the instrument are paid out of the System institution's net income, unallocated retained earnings, or surplus related to other AT1 capital instruments and are not subject to a limit imposed by the contractual terms governing the instrument;

(9) The instrument does not have a credit-sensitive feature, such as a dividend rate that is reset periodically based in whole or in part on the System institution's credit quality, but may have a dividend rate that is adjusted periodically independent of the System institution's credit quality, in relation to general market interest rates or similar adjustments;

(10) The paid-in amount is classified as equity under GAAP;

(11) The System institution did not purchase or directly or indirectly fund the purchase of the instrument;

(12) The instrument does not have any features that would limit or discourage additional issuance of capital by the System institution, such as provisions that require the System institution to compensate holders of the instrument if a new instrument is issued at a lower price during a specified timeframe; and

(13) The System institution's capitalization bylaws provide that it will not redeem the instrument without the prior approval of the FCA.

Notwithstanding the criteria for AT1 capital instruments referenced above, an instrument with terms that provide that the instrument may be called earlier than 5 years upon the occurrence of a rating agency event does not violate the minimum 5-year issuance requirement provided that the instrument was issued and included in a System institution's core surplus capital prior to the effective date of the final rule, and that such instrument satisfies all other criteria under this § 628.20(c).

b. FCA's Current Capital Regulations

Under the FCA's current regulatory capital regulations, the outstanding noncumulative perpetual preferred stock issued by System institutions to third parties is included in core surplus and is included in the minimum required 1.5 percent of core surplus that is other than allocated equities routinely redeemed. Such preferred stock would continue to receive favorable regulatory capital treatment in tier 1 capital. However, consistent with the objective of Basel III and the Federal regulatory banking agencies' rules that banking

organizations' common equities comprise at least 4.5 percent of risk-based capital, the preferred stock would not be included in CET1.

3. Tier 2 Capital

The FCA proposes to include in tier 2 capital the sum of tier 2 capital instruments that satisfy the applicable criteria, plus ALL up to 1.25 percent of risk-weighted assets, less any applicable adjustments and deductions. The criteria are similar to those in Basel III and the Federal regulatory banking agencies' rules, except that common cooperative equities that are not includable in CET1 may be included in tier 2 if they meet the applicable criteria.

The criteria for instruments (plus related surplus) included in tier 2 capital are:

(1) The instrument is issued and paid-in, is a common cooperative equity, or is member equity purchased in accordance with § 628.20(d)(1)(viii) of the proposed rule;

(2) The instrument is subordinated to general creditors of the System institution;

(3) The instrument is not secured, not covered by a guarantee of the System institution and not subject to any other arrangement that legally or economically enhances the seniority of the instrument in relation to more senior claims;

(4) The instrument has a minimum original maturity of at least 5 years. At the beginning of each of the last 5 years of the life of the instrument, the amount that is eligible to be included in tier 2 capital is reduced by 20 percent of the original amount of the instrument (net of redemptions) and is excluded from regulatory capital when the remaining maturity is less than 1 year. In addition, the instrument must not have any terms or features that require, or create significant incentives for, the System institution to redeem the instrument prior to maturity;³²

(5) The instrument, by its terms, may be called by the System institution only after a minimum of 5 years following issuance, except that the terms of the instrument may allow it to be called sooner upon the occurrence of an event that would preclude the instrument from being included in tier 2 capital, or a tax event. In addition:

(a) The System institution must receive the prior approval of FCA to exercise a call option on the instrument.

³² An instrument that by its terms automatically converts into a tier 1 capital instrument prior to 5 years after issuance complies with the 5-year maturity requirement of this criterion.

³¹ Replacement can be concurrent with redemption of existing AT1 capital instruments.

(b) The System institution does not create at issuance, through action or communication, an expectation the call option will be exercised.

(c) Prior to exercising the call option, or immediately thereafter, the System institution must either: Replace any amount called with an instrument that is of equal or higher quality regulatory capital under this section;³³ or demonstrate to the satisfaction of FCA that following redemption, the System institution would continue to hold an amount of capital that is commensurate with its risk;

(6) The holder of the instrument must have no contractual right to accelerate payment of principal, dividends, or interest on the instrument, except in the event of a receivership, insolvency, liquidation, or similar proceeding of the System institution;

(7) The instrument has no credit-sensitive feature, such as a dividend or interest rate that is reset periodically based in whole or in part on the System institution's credit standing, but may have a dividend rate that is adjusted periodically independent of the System institution's credit standing, in relation to general market interest rates or similar adjustments;

(8) The System institution has not purchased and has not directly or indirectly funded the purchase of the instrument, except that where common cooperative equity instruments are held by a member of the institution in connection with a loan, and the institution funds the acquisition of such instruments, that loan shall not be considered as a direct or indirect funding where:

(a) The purpose of the loan is not the purchase of capital instruments of the System institution providing the loan;

(b) The purchase or acquisition of one or more capital instruments of the institution is necessary in order for the beneficiary of the loan to become a member of the System institution; and

(c) The capital instruments are in excess of the statutory minimum stock purchase amount;

(9) Redemption of the instrument prior to maturity or repurchase is at the discretion of the System institution and requires the prior approval of the FCA; and

(10) If the instrument is a common cooperative equity, the System institution's capitalization bylaws provide that it will not, except with the prior approval of the FCA, redeem such equity included in tier 2 capital for a

period of at least 5 years after allocating it to a member.

4. FCA Approval of Capital Elements

Proposed § 628.20(e) would require a System institution to obtain prior approval to include a new capital element in its CET1 capital, AT1 capital, or tier 2 capital unless the element is equivalent, in terms of capital quality and ability to absorb losses with respect to all material terms, to a regulatory element the FCA has already determined may be included in regulatory capital. After the FCA determines that an institution may include an element in regulatory capital, it will make its decision publicly available.

5. FCA Prior Approval Requirements for Cash Patronage, Dividends, and Redemptions; Safe Harbor

As described above, the proposed rule would require FCA prior approval for the redemption of equities included in tier 1 and tier 2, consistent with Basel III and the Federal regulatory banking agencies' rules. The proposed rule would also require FCA prior approval of cash dividends and cash patronage, which is not a requirement of the Basel III framework but is a requirement imposed by statute or regulation on the federally chartered banking organizations regulated by the Federal regulatory banking agencies. In § 628.20(f), we are also proposing a "safe harbor" to permit institutions to pay cash dividends and patronage and to redeem equities with "deemed" FCA prior approval if the payments are within the specified parameters.

Before a Federal savings association declares a dividend, it must send a notice, or application for approval, of the action to the Office of the Comptroller of the Currency (OCC). Whether OCC approval is required or a mere notice will suffice depends on a number of factors. For example, an application for approval is required if the proposed declaration (together with all other capital distributions) for the applicable calendar year exceeds the savings association's net income for the current year plus the retained net income for the 2 preceding years.³⁴ A national bank must obtain OCC approval to declare a dividend if the total amount of all common and preferred dividends, including the proposed dividend, declared in any current year exceeds the total of the national bank's net income of the current year to date, combined with the

retained net income of the previous 2 years.³⁵

The FCA's proposed rule would not require System institutions to obtain prior approval to retire member stock up to an amount equal to the Farm Credit Act's minimum member stock requirement of \$1,000 or 2 percent of the loan, whichever is less. In addition, subject to any restrictions on cash payouts under the capital conservation buffer provision in § 628.11, the proposed safe harbor would provide that FCA prior approval is deemed to be granted for cash distributions to pay dividends, patronage, or revolvments and redemptions of common cooperative equities provided that:

- For revolvments or redemptions of common cooperative equities included in CET1 capital, such equities were issued or distributed at least 10 years ago;

- For revolvments or redemptions of common cooperative equities included in tier 2 capital, such equities were issued or distributed at least 5 years ago;

- After such cash distributions, the dollar amount of the System institution's CET1 capital equals or exceeds the dollar amount of CET1 capital on the same date in the previous calendar year; and

- After such cash distributions, the System institution continues to comply with all regulatory capital requirements and supervisory or enforcement actions.

System institutions do not generally have to obtain FCA prior approval before paying patronage or dividends or redeeming equities under current regulations, nor does the Farm Credit Act require prior approval. However, it is a fundamental principle of the regulatory capital requirements for U.S. banking organizations regulated by the Federal regulatory banking agencies. In order for the regulatory capital framework that applies to System institutions to be comparable to the regulatory capital framework that applies to U.S. banking organizations, we believe it is necessary to include these prior approval requirements in our proposed rule. We believe that, most of the time, most System institutions will be able to pay cash patronage and dividends and redeem equities to the same extent that they do currently.

B. Regulatory Adjustments and Deductions

1. Regulatory Deductions From CET1 Capital

Under the proposal, a System institution must deduct from CET1

³³ A System institution may replace tier 2 or tier 1 capital instruments concurrent with the redemption of existing tier 2 capital instruments.

³⁴ 12 CFR 163.140–163.46.

³⁵ 12 U.S.C. 60(b).

capital the items described in § 628.22 of the proposed rule. A System institution would exclude these deductions from its total risk-weighted assets and leverage exposure. These deductions are:

a. Goodwill and Other Intangibles (Other Than Mortgage Servicing Assets)

Consistent with Basel III and the Federal regulatory banking agencies' rules, the FCA proposes to exclude goodwill and other intangible assets from regulatory capital because of the uncertainty that a System institution may realize value from these assets under adverse financial conditions. An institution would deduct goodwill and "non-mortgage" servicing assets, net of associated deferred tax liabilities (DTLs), from CET1 capital. (The FCA's current capital regulations require goodwill to be deducted from regulatory capital.) While intangible assets include mortgage servicing assets (MSAs), the MSAs are subject to a different treatment from other intangible assets under Basel III and the Federal banking regulatory agencies' rules. In Basel III and the agencies' rules, the MSAs, along with two other items—significant investments in the common shares of unconsolidated financial institutions and deferred tax assets (DTAs) that arise from temporary differences—are given limited recognition in a banking organization's CET1, with recognition capped at 10 percent of CET1 for each item (*i.e.*, a "threshold deduction" of 10 percent). There is also a threshold deduction of 15 percent on the aggregate of the three items, and any included MSAs are risk weighted at 250 percent.

The FCA is not proposing to implement the threshold deductions for these three items. We believe that no System institution's MSAs would meet the 10- and 15-percent thresholds. The proposed rule would require System institutions to assign a risk weight to MSAs of 100 percent, as they do in current FCA regulations. Traditionally, System institutions follow the make-and-hold philosophy when it comes to its loan assets. As a result, only a few System institutions have sold loans to Farmer Mac or other parties for securitization. Should the levels of MSAs held by System institutions increase significantly in the future, the FCA may reconsider the appropriateness of this proposed treatment.

The FCA is not proposing the threshold deduction in Basel III and the Federal regulatory banking agencies' rules for investments in other financial institutions because it is proposing that System institutions deduct their

investments in other System institutions from their regulatory capital, as described below. Other equity investments will be risk weighted according to § 628.51.

We do not believe DTAs that are risk weighted in this section would represent material items on a System institution's balance sheet because of System institutions' tax status. The FCBs and FLCAs are exempt from Federal, state, municipal, and local taxation.³⁶ Most other System institutions' net income arises from both non-taxable and taxable sources. The production and cooperative lending business lines are taxable, but the ACB and taxable System associations may reduce taxes by following Subchapter T provisions of the Internal Revenue Code. Therefore, we do not expect large amounts of DTAs and deferred tax liabilities (DTLs) on a System institution's balance sheet. Should the levels of DTAs held by System institutions increase significantly in the future, the FCA may reconsider the appropriateness of this proposed treatment.

We seek comment on whether FCA should risk weight MSAs at 100 percent or require deduction of MSAs from CET1, as we propose to do for non-mortgage servicing rights. At the present time, FCA does not consider any type of servicing asset material to a System institution's or the System's consolidated balance sheet.

b. Gain-on-Sale Associated With a Securitization Exposure

A System institution would deduct from CET1 capital any after-tax gain-on-sale associated with a securitization exposure. Under GAAP, any gain-on-sale from a traditional securitization would increase a System institution's CET1 capital. However, if a System institution received cash from the sale of the securitization exposure and the MSA, it would not deduct such amount from its CET1 capital. Any sale of loans to a securitization structure that creates a gain may include an MSA that also meets the proposed definition of "gain-on-sale." A System institution must exclude any portion of a gain-on-sale reported as an MSA on FCA's Call Report.

c. Defined Benefit Pension Fund Net Assets

A System institution must deduct from CET1 capital a defined benefit pension fund asset (an overfunded

pension), net of any associated DTLs, because of the uncertainty of realizing any of the value from such assets. This proposed rule recognizes under GAAP the amount of a defined benefit pension fund liabilities (an underfunded pension) on the balance sheet of the institution, would be the same amount included as CET1 capital. Therefore, a System institution must not increase its CET1 capital by the derecognition of these defined pension fund liabilities.

Currently, FCA regulations do not require the deduction of the defined benefit pension fund net assets in the regulatory capital calculations. Additionally, our call report does not collect defined benefit pension fund assets. To implement this regulation, FCA will develop a call report schedule and require each System institution to report its individual yearend transactions for defined benefit pension assets on their individual call report schedule. At this time, some System institutions report their yearend transactions for defined benefit pension assets on their institution-only shareholder reports. Others, however, collectively report their yearend transactions for defined benefit pension assets in the district-wide shareholder report.

Comparable to Basel III, a System institution would not be required to deduct defined benefit pension fund assets to which the System institution has unrestricted and unfettered access. In this case, the System institution would assign risk weights to such assets as if the institution directly owned them. Under this proposal, unrestricted and unfettered access would mean that an institution is not required to request and receive specific approval from pension beneficiaries each time it would access funds in the plan.

Any portion of the defined benefit pension fund net assets not deducted by an institution must be risk-weighted as if the System institution directly held a proportional ownership share of each exposure in the defined benefit pension fund. For example, assume that: (1) The institution has a defined benefit pension fund net asset of \$10; and (2) the institution has unfettered and unrestricted access to the assets of the defined benefit pension fund. Also, assume that 20 percent of the defined benefit pension fund is risk-weighted at 100 percent and 80 percent is risk-weighted at 300 percent. The institution would risk weight \$2 at 100 percent and \$8 at 300 percent. This treatment would be consistent with the full look-through approach described in § 628.53(b) of the proposed rule.

³⁶ They are subject to taxes on real estate held to the same extent, according to its value, as other similar property held by other persons is taxed. See 12 U.S.C. 2023 and 2098.

Given System institutions' differing methods of reporting defined benefit pension fund assets, what is the best way to require adjustments for defined benefit pension fund assets in the CET1 capital computation?

d. A System Institution's Allocated Equity Investment in Another System Institution

The proposed rule would require a System institution to deduct any allocated equity investment in another System institution³⁷ from its CET1 capital pursuant to § 628.22(a). Later in this preamble, we will discuss deducting a System institution's purchased investment in another System institution using the corresponding deduction approach in § 628.22(c). Other equity exposures are covered in § 628.52.

The FCA is proposing a different equity elimination method from the Federal banking regulatory agencies' rules. We believe the method proposed is more conservative than the banking agencies' rules but is more appropriate for System institutions and is consistent with the principles of Basel III. It is also simpler to calculate. System associations, as members of a cooperative network, have equity investments in their affiliated banks. System institutions also have equity investments in other System institutions but few outside the System. As we have discussed earlier in the preamble, the investments that System institutions have in other System institutions are counted in their GAAP financial statements as equity of the issuing or allocating institution and as assets of the recipient institution. The FCA continues to believe, as we have stated numerous times previously, that equities should be counted in the regulatory capital of the institution that has control of the equities. The allocating institutions alone have discretion whether to allocate equities and when, if ever, to distribute those equities. Therefore, under this proposal, the allocating institutions would include in their CET1 capital the equities they have allocated to their members, provided those equities meet the criteria for inclusion in CET1 capital. The institutions that have received allocated equities from other institutions must deduct those equities from their CET1 capital.

Under the proposed rule, System institutions will be able to include allocated equities in CET1 capital that are excluded from core surplus under

current regulations. The proposed deductions apply only to investments in other System institutions because, for the most part, our investment regulations restrict equity investments outside the System.

e. "Haircut" Deduction for Redemption of Equities Included in CET1 Capital Less Than 10 Years After Issuance or Allocation

Section 628.22(f) of the proposed rule would provide that, if a System institution redeems equities included in CET1 capital that the institution issued or allocated less than 10 years before, and the institution did not receive prior FCA approval, the institution must exclude 30 percent of the remaining purchased and allocated equities otherwise includable in CET1 capital. That amount must be excluded from CET1 for the next 3 years; during those 3 years the amount excluded from CET1 may be included in tier 2 capital if it otherwise qualifies for tier 2 capital. This haircut would not be imposed on allocated equities that are URE equivalents unless such equities redeemed without FCA approval were URE equivalents, nor would it be imposed for redemptions of a member's minimum borrower stock requirement.

The FCA is proposing this deduction to ensure proper management by System institutions of their members' expectations of redemption and also to ensure that institutions are vigilant in their recordkeeping of the issuance and allocation dates of CET1 capital. For most System institutions that redeem equities on a regular basis, the 10-year minimum retention requirement will result in a longer revolvment period, especially for allocated equities, and will likely require some member education about the longer period. It is important that members know they cannot reasonably expect redemption of the equities that their institution includes in CET1 capital in a shorter timeframe than 10 years.

2. The Corresponding Deduction Approach for Purchased Equities

Section 628.22(c) of this proposal incorporates the Basel III corresponding deduction approach for a System institution's purchased equity investment in another System institution. The corresponding deduction approach does not apply to allocated equity investments in another System institution. Under the proposal, a System institution would be required to deduct an amount from the same component of capital for which the underlying instrument would qualify as if the System institution had issued the

instrument itself. If a System institution did not have a sufficient amount of the specific component of regulatory capital for the entire deduction, then it would deduct the remaining portion from the next higher (more subordinated) capital component. Should a System institution not have enough AT1 capital to satisfy the required deduction, the shortfall would be deducted from CET1 capital elements.

3. Netting of Deferred Tax Liabilities Against Deferred Tax Assets and Other Deductible Assets

In this proposed rule, FCA would simplify the netting of DTLs against DTAs and other deductible assets for deductions of DTAs. This proposal differs from the Federal banking regulatory agencies' final rules for deductions of DTAs. For System institutions, this proposal also represents a change from our existing DTAs deduction regulation. Under the proposal, System institutions would adjust CET1 capital under § 628.22(b) of the proposed rule net of any associated deferred tax effects. In addition, System institutions would deduct from CET1 capital elements under § 628.22(a) and (c) of the proposed rule net of associated DTLs, pursuant to § 628.22(e).

Currently System institution deduct DTAs according to § 615.5209 of FCA regulations. A System institution must deduct an amount of DTAs from its assets and its total capital that is equal to the greater of the two following conditions: (1) An amount of DTAs that is dependent on future income; or (2) an amount of DTAs that is dependent on future income in excess of 10 percent of the amount of core surplus.³⁸

For this proposed regulation, FCA categorized DTAs into three types. First, there are DTAs that arise from temporary differences that a System institution could realize through a net loss carryback.³⁹ Since System institutions have recognized or projected to realize these temporary differences in current income, a System institution would assign these DTAs a risk weight of 100 percent. Second, there are DTAs that arise from temporary differences that a System institution could not realize through net loss carryback.⁴⁰ And third, there are DTAs that arise from operating loss and tax credit carryforwards.⁴¹ A System

³⁸ That exists before the deduction of any deferred-tax assets.

³⁹ Net of any valuation allowances.

⁴⁰ Net of any valuation allowances.

⁴¹ Net of any valuation allowances.

³⁷ An example would be an association's equity investment in its System bank.

institution would deduct the latter two DTAs subject to § 628.22(c).

Under the proposal, System institutions making regulatory capital deductions under § 628.22 would net DTLs against assets to which they are associated (other than DTAs). Should the asset to which the DTL is associated become impaired or derecognized under GAAP, the System institution would extinguish the DTL. Likewise, System institutions may only use the same DTL once for netting purposes. This practice is consistent with the netting DTLs against goodwill.

System institutions would net DTLs against DTAs that arise from temporary differences that a System institution could not realize through net loss carrybacks,⁴² and DTAs that arise from operating loss and tax credit carryforwards⁴³ provided certain conditions exist: (1) A System institution would net only DTLs and DTAs related to taxes levied by the same taxation authority and eligible for offsetting by that authority; and (2) the amount of DTLs that a System institution would be able to net against DTAs that arise from loss carryforwards,⁴⁴ and against DTAs arising from temporary differences that could not be realized through loss carrybacks,⁴⁵ would be allocated in proportion to the amount of DTAs that arise from loss carryforwards⁴⁶ and of DTAs arising from temporary differences that could not be realized through net operating loss carrybacks.⁴⁷

GAAP requires quarterly adjustment for some DTA and DTL items, such as DTAs and DTLs associated with certain gains and losses included in AOCI. Therefore, the FCA expects System institutions to use for regulatory capital calculations the DTA and DTL amounts reported in the regulatory reports. The proposed rule does not require System institutions to perform these calculations more often than would be required to meet quarterly regulatory reporting requirements.

The FCA would allow System institutions to treat future taxes payable

included in valuing a leveraged lease portfolio as a reversing taxable temporary difference available to support recognizing DTAs.⁴⁸ The proposed rule allows a System institution to use the DTLs embedded in the carrying value of a leveraged lease to reduce the amount of DTAs consistent with § 628.22(e).

The FCA recognizes that, if the tax laws of the relevant state and local jurisdictions do not differ significantly from Federal income tax laws, then under GAAP the calculation of deferred tax expense can be made in the aggregate considering the combination of Federal, state, and local income tax rates. The rate used should consider whether amounts paid in one jurisdiction are deductible in another jurisdiction. For example, since state and local taxes are deductible for Federal income tax purposes, the aggregate combined rate would generally be (1) The Federal income tax rate plus (2) the state and local tax rates, minus (3) the Federal tax effect of the deductibility of the state and local taxes at the Federal tax rate. In addition, for financial reporting purposes, consistent with GAAP, the FCA allows System institutions to offset DTAs (net of valuation allowance) and DTLs related to a particular tax jurisdiction. Moreover, for regulatory reporting purposes, consistent with GAAP, the FCA requires separate calculations of income taxes, both current and deferred amounts, for each tax jurisdiction. Accordingly, System institutions must calculate DTAs and DTLs on a state-by-state basis for financial reporting purposes under GAAP and for regulatory reporting purposes.

Under the proposed rule, a System institution must assign a risk weight of 100 percent under § 628.30 for DTAs that arise from temporary differences that a System institution may realize through net operating loss carrybacks. By this proposal, the FCA would allow System institutions to include in regulatory capital some or all of their

DTAs resulting from timing differences that are realizable through net operating loss carrybacks. In this regard, we believe the proposed rule strikes an appropriate balance between prudential concerns and practical considerations about the ability of System institutions to realize DTAs.

C. Limits on Inclusion of Third-Party Capital

The proposed rule would impose limits on System institution issuances of third-party capital—that is, capital issued to entities that are not System institutions or members of System institutions—in regulatory capital.⁴⁹ The FCA currently imposes limits on the inclusion of third-party capital in core surplus, total surplus, and net collateral on a case-by-case basis in connection with our clearance of disclosure documents and regulatory capital determinations. The FCA has imposed this restriction to ensure that cooperative ownership continues to predominate in all System institutions, in order to maintain the status of the System as a member-controlled GSE that is owned by and primarily benefits its members.

The proposed rule would provide that third-party capital when issued, together with any already outstanding third-party capital in tier 1 capital, may be included in tier 1 capital in an amount up to 33 percent of all other tier 1 capital (*i.e.*, 25 percent of all tier 1 capital including third-party capital). It may be included in total capital in an amount equal to the lesser of 40 percent of total capital or 100 percent of tier 1 capital.

The two formulas are:

$$1. \text{ALTPC} = \min(40 \text{ percent TC}, 100 \text{ percent T1}),$$

where,

ALTPC = Aggregate limit on third-party capital

TC = Total capital (tier 1 Capital + tier 2 Capital)

T1 = Tier 1 capital

$$2. \text{CLNPPS} = \max \left[\text{ELNPPS}, \quad 1/3 \left(\sum_{n=1}^4 \frac{(\text{T1}_n - \text{NPPS}_n)}{4} \right) \right]$$

⁴² Net of any valuation allowances.

⁴³ Net of any valuation allowances.

⁴⁴ Net of any valuation allowances.

⁴⁵ Net of any valuation allowances.

⁴⁶ Net of any valuation allowances, but before any offsetting of DTLs.

⁴⁷ Net of any valuation allowances, but before any offsetting of DTLs.

⁴⁸ Temporary differences arise when financial events or transactions are recognized in one period for financial reporting purposes and in another period, or periods, for tax purposes. A reversing taxable temporary difference is a temporary difference that produces additional taxable income in future periods.

⁴⁹ The FCA notes that System institution members could hold third-party equities that are

issued to groups of persons such as individual accredited investors, if they are qualified to purchase the stock and are not prohibited to do so under conditions imposed by FCA. We use the term “third-party” to refer to a class of stock other than the classes of stock that only a System institution’s members are eligible to purchase.

where

CLNPPS = current limit on noncumulative perpetual preferred stock in tier 1 capital, calculated this quarter
 ELNPPS = existing limit on noncumulative perpetual preferred stock in tier 1 capital, calculated the previous quarter,
 NPPS = noncumulative perpetual preferred stock included in tier 1 capital,
 T1 = tier 1 capital, and
 n = 4 previous quarters, 1–4

We seek comment on alternative third-party limits to ensure that System institutions remain capitalized primarily by their member borrowers.

IV. Standardized Approach for Risk-Weighted Assets

A. Calculation of Standardized Total Risk-Weighted Assets

Similar to the FCA's current risk-based capital rules, under this proposal a System institution would calculate its total risk-weighted assets by adding together its on- and off-balance sheet risk-weighted asset amounts and making any relevant adjustments to incorporate required capital deductions.⁵⁰ Risk-weighted asset amounts generally would be determined by assigning on-balance sheet assets to broad risk-weight categories according to the counterparty or, if relevant, the guarantor or collateral. Similarly, risk-weighted asset amounts for off-balance sheet items would be calculated using a two-step process: (1) Multiplying the amount of the off-balance sheet exposure⁵¹ by a credit conversion factor (CCF) to determine a credit equivalent amount; and (2) assigning the credit equivalent amount to a relevant risk-weight category.

A System institution would determine its standardized total risk-weighted assets by calculating the sum of its risk-weighted assets for general credit risk, cleared transactions, unsettled transactions, securitization exposures, and equity exposures, each as defined below, less the System institution's allowance for loan losses (ALL) that is not included in tier 2 capital (as described in § 628.20 of the proposal). The sections below describe in more detail how a System institution would determine the risk-weighted asset amounts for its exposures.

B. Risk-Weighted Assets for General Credit Risk

Under this proposed rule, total risk-weighted assets for general credit risk is the sum of the risk-weighted asset

amounts as calculated under § 628.31(a) of the proposal. As proposed, general credit risk exposures would include a System institution's on-balance sheet exposures (other than cleared transactions, securitization exposures, and equity exposures, each as defined in § 628.2 of the proposed rule), exposures to over-the-counter (OTC) derivative contracts, off-balance sheet commitments, trade and transaction-related contingencies, guarantees, repo-style transactions, financial standby letters of credit, forward agreements, or other similar transactions. Proposed § 628.32 describes the risk weights that would apply to sovereign exposures; exposures to certain supranational entities and multilateral development banks (MDBs); exposures to Government-sponsored enterprises (GSEs); exposures to depository institutions, foreign banks, and credit unions (including certain exposures to other financing institutions (OFIs) owned or controlled by these entities); exposures to public sector entities (PSEs); corporate exposures (including certain exposures to OFIs); residential mortgage exposures; high volatility commercial real estate (HVCRE) exposures; past due exposures; other assets (including cash, gold bullion, certain MSAs and DTAs); and loans from System banks to associations.

Generally, the exposure amount for the on-balance sheet component of an exposure would be the System institution's carrying value for the exposure as determined under generally accepted accounting principles (GAAP). Because all System institutions use GAAP to prepare their financial statements and regulatory reports, we believe that using GAAP to determine the amount and nature of an exposure provides a consistent framework that System institutions can easily apply. Using GAAP for this purpose would reduce the potential burden that could otherwise result from requiring System institutions to comply with a separate set of accounting and measurement standards for risk-based capital calculation purposes under non-GAAP standards, such as regulatory accounting practices or legal classification standards.

For purposes of the definition of exposure amount for available-for-sale (AFS) or held-to-maturity (HTM) debt securities and AFS preferred stock not classified as equity under GAAP, the exposure amount is the System institution's carrying value (including net accrued but unpaid interest and fees) for the exposure, less any net unrealized gains, and plus any net unrealized losses. For purposes of the

definition of exposure amount for AFS preferred stock classified as an equity security under GAAP, the exposure amount is the System institution's carrying value (including net accrued but unpaid interest and fees) for the exposure, less any net unrealized gains that are reflected in such carrying value but excluded from the System institution's regulatory capital.⁵²

In most cases, the exposure amount for an off-balance sheet component of an exposure would typically be determined by multiplying the notional amount of the off-balance sheet component by the appropriate CCF as determined under § 628.33 of the proposed rule. The exposure amount for an OTC derivative contract or cleared transaction that is a derivative would be determined under § 628.34 of the proposed rule, whereas exposure amounts for collateralized OTC derivative contracts, collateralized cleared transactions that are derivatives, repo-style transactions, and eligible margin loans would be determined under § 628.37 of the proposal.

1. Exposures to Sovereigns

Under the proposal, a sovereign would be defined as a central government (including the U.S. Government) or an agency, department, ministry, or central bank of a central government (for the U.S. Government, the central bank is the Federal Reserve). The FCA proposes to retain the current rules' risk weights for exposures to and claims directly and unconditionally guaranteed by the U.S. Government or its agencies.⁵³ Accordingly, exposures to the U.S. Government, the Federal Reserve, or a U.S. Government agency, and the portion of an exposure that is directly and unconditionally guaranteed by the U.S. Government, the Federal Reserve, or a U.S. Government agency would receive a 0-percent risk weight.⁵⁴ Consistent with the current risk-based capital rules, the portion of a deposit insured by the Federal Deposit Insurance Corporation (FDIC) or the National Credit Union Administration (NCUA) would also be assigned a 0-percent risk weight.

⁵² Although System banks often classify their securities as AFS, associations almost always classify their securities, to the extent they hold any, as HTM.

⁵³ A U.S. Government agency would be defined in the proposal as an instrumentality of the U.S. Government whose obligations are fully guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. Government.

⁵⁴ Similar to the FCA's current risk-based capital rules, a claim would not be considered unconditionally guaranteed by a central government if the validity of the guarantee is dependent upon some affirmative action by the holder or a third party.

⁵⁰ See generally the FCA's regulations at part 615, subpart H.

⁵¹ The term "exposure," which would be defined as an amount at risk, is used throughout the proposed rule and preamble.

An exposure conditionally guaranteed by the U.S. Government, the Federal Reserve, or a U.S. Government agency would receive a 20-percent risk weight.⁵⁵ This would include an exposure that is conditionally guaranteed by the FDIC or the NCUA.

The FCA's existing risk-based capital rules generally assign risk weights to direct exposures to sovereigns and exposures directly guaranteed by sovereigns based on whether the sovereign is a member of the Organization for Economic Cooperation and Development (OECD) and, as applicable, whether the exposure is unconditionally or conditionally guaranteed by the sovereign.⁵⁶

The OECD assigns Country Risk Classifications (CRCs) to many countries as an assessment of their credit risk. CRCs are used to set interest rate charges for transactions covered by the OECD arrangement on export credits. The OECD uses a scale of 0 to 7 with 0 being the lowest possible risk and 7 being the highest possible risk. The OECD no longer assigns CRCs to certain high-income countries that are members of the OECD and that have previously received a CRC of 0. These countries exhibit a similar degree of country risk as that of a jurisdiction with a CRC of 0.⁵⁷

Under the proposed rule, the risk weight for exposures to countries with CRCs would be determined based on the CRCs. Exposures to OECD member countries that do not have CRCs would be risk-weighted at 0-percent. Exposures to non-OECD members with no CRC would be risk-weighted at 100-percent.⁵⁸ The OECD regularly updates CRCs and makes the assessments publicly available on its Web site. Accordingly, the FCA believes that the CRC approach should not represent undue burden to System institutions.

⁵⁵ Because of the issues such an exposure would raise, the FCA would determine the risk-weight of any System institution exposures that has a Farm Credit System Insurance Corporation (FCSIC) guarantee, whether conditional or unconditional, on a case-by-case basis.

⁵⁶ Section 615.5211.

⁵⁷ For more information on the OECD country risk classification methodology, see generally OECD, "Country Risk Classification," available at <http://www.oecd.org/tad/xcred/crc.htm>.

⁵⁸ This proposed rule, like the capital rules of the Federal banking regulatory agencies, permits a lower risk weighting for sovereign exposures if certain conditions are met, including that the exposure is denominated in the sovereign's currency. Although the investment eligibility regulation applicable to System institutions require that all investments must be denominated in U.S. dollars (see § 615.5140(a) of our regulations), this lower risk weight could be used if a System institution were to foreclose on collateral in the form of such a sovereign exposure.

The FCA believes that use of CRCs in the proposal is permissible under section 939A of the Dodd-Frank Act and that section 939A was not intended to apply to assessments of creditworthiness by organizations such as the OECD. Section 939A is part of Subtitle C of Title IX of the Dodd-Frank Act, which, among other things, enhances regulation by the U.S. Securities and Exchange Commission (SEC) of credit rating agencies, including Nationally Recognized Statistical Rating Organizations (NRSROs) registered with the SEC. Section 939A requires agencies to remove references to credit ratings and NRSROs from Federal regulations. In the introductory "findings" section to Subtitle C, which is entitled "Improvements to the Regulation of Credit Ratings Agencies," Congress characterized credit rating agencies as organizations that play a critical "gatekeeper" role in the debt markets and perform evaluative and analytical services on behalf of clients, and whose activities are fundamentally commercial in character.⁵⁹ Furthermore, the legislative history of section 939A focuses on the conflicts of interest of credit rating agencies in providing credit ratings to their clients, and the problem of government "sanctioning" of the credit rating agencies' credit ratings by having them incorporated into Federal regulations. 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. Additionally, the FCA notes that the use of the CRCs is limited in the proposal. The FCA considers CRCs to be a reasonable alternative to credit ratings for sovereign exposures and the proposed CRC methodology to be more granular and risk sensitive than the current risk-weighting methodology based solely on OECD membership.

The FCA also proposes to require a System institution to apply a 150-percent risk weight to sovereign exposures immediately upon determining that an event of sovereign default has occurred or if an event of sovereign default has occurred during the previous 5 years. Sovereign default would be defined as a noncompliance by a sovereign with its external debt service obligations or the inability or unwillingness of a sovereign government to service an existing loan according to its original terms, as evidenced by failure to pay principal or interest fully and on a timely basis,

⁵⁹ See Dodd-Frank Act, section 931 (15 U.S.C. 780-7 note).

arrearages, or restructuring. A default would include a voluntary or involuntary restructuring that results in a sovereign not servicing an existing obligation in accordance with the obligation's original terms.

TABLE 3—RISK WEIGHTS FOR SOVEREIGN EXPOSURES

	Risk weight (in percent)
CRC:	
0-1	0
2	20
3	50
4-6	100
7	150
OECD Member with No CRC ...	0
Non-OECD Member with No CRC	100
Sovereign Default	150

2. Exposures to Certain Supranational Entities and Multilateral Development Banks

Under the FCA's existing risk-based capital rules, exposures to certain supranational entities and multilateral development banks (MDBs) receive a 20-percent risk weight. Consistent with the Basel framework's treatment of exposures to supranational entities, the FCA proposes to apply a 0-percent risk weight to exposures to the Bank for International Settlements, the European Central Bank, the European Commission, and the International Monetary Fund.

Similarly, the FCA proposes to apply a 0-percent risk weight to exposures to an MDB. The proposal would define an MDB to 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 U.S. Government is a shareholder or contributing member or which the FCA determines poses comparable credit risk.

The FCA believes this treatment is appropriate in light of the generally high-credit quality of MDBs, their strong shareholder support, and a shareholder structure comprised of a significant proportion of sovereign entities with

strong creditworthiness. Exposures to regional development banks and multilateral lending institutions that are not covered under the definition of MDB generally would be treated as corporate exposures and would receive a 100-percent risk weight.

3. Exposures to Government-Sponsored Enterprises

The System is a GSE, and the definition of GSE adopted by the Federal banking regulatory agencies includes the System in their definition of GSE.⁶⁰ Those agencies view the System, and the other GSEs, as potential counterparties to the entities that they regulate. In contrast, we regulate System institutions rather than viewing them as potential counterparties. It is too confusing for the System to be included in a definition that is intended to refer to counterparties. Accordingly, we propose for the purpose of these capital regulations at part 628 to exclude institutions of the System (other than the Federal Agricultural Mortgage Corporation (Farmer Mac)) from the definition of GSE.⁶¹ Throughout these capital regulations, we will refer to System institutions specifically as necessary.

The FCA is proposing to assign a 20-percent risk weight to exposures to GSEs that are not equity exposures and a 100-percent risk weight to preferred stock issued by a GSE.⁶² This risk weighting would represent a change to the FCA's existing risk-based capital rules, which currently allow a System institution to apply a 20-percent risk weight to GSE preferred stock.⁶³

4. Exposures to Depository Institutions, Foreign Banks, and Credit Unions

The FCA's existing risk-based capital rules assign a 20-percent risk weight to all exposures to U.S. depository institutions and foreign banks incorporated in an OECD country. Short-term exposures to foreign banks incorporated in a non-OECD country receive a 20-percent risk weight and long-term exposures to such entities receive a 100-percent risk weight.

⁶⁰ The definition of GSE adopted by the Federal banking regulatory agencies includes the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the System, and the Federal Home Loan Bank System.

⁶¹ Farmer Mac would remain included in the FCA's definition of GSE, because this regulation would view Farmer Mac as a counterparty rather than as a regulated entity.

⁶² As discussed below, System institutions would be required to deduct from capital preferred stock (and all other equities) issued by other System institutions, and therefore we do not propose a risk weight for these exposures.

⁶³ Section 615.5211(b)(6).

Under the proposal, exposures to U.S. depository institutions and credit unions would be assigned a 20-percent risk weight.⁶⁴ This risk weight would apply to a System bank exposure to an OFI that is owned and controlled by a U.S. or state depository institution or credit union that guarantees the exposure. If the OFI exposure did not satisfy these requirements, it would be assigned a 100-percent risk weight as a corporate exposure pursuant to § 628.32(f)(2).

Our existing OFI rules assign a 20-percent risk weight to a claim on an OFI that is an OECD bank or is owned and controlled by an OECD bank that guarantees the claim or if the OFI or its parent has a sufficiently high credit rating.⁶⁵ Our proposal would impose the same risk weight for OFI exposures of the same nature, except that we propose to eliminate the credit rating alternative in accordance with section 939A of the Dodd-Frank Act.

Under this proposal, an exposure to a foreign bank would receive a risk weight one category higher than the risk weight assigned to a direct exposure to the foreign bank's home country, based on the assignment of risk weights by CRC, as discussed above.⁶⁶ Exposures to a foreign bank in a country that does not have a CRC but that is a member of the OECD would receive a 20-percent risk weight. A System institution would assign a 100-percent risk weight to an exposure to a foreign bank in a non-OECD member country that does not have a CRC, except that the institution could assign a 20-percent risk weight to self-liquidating, trade-related contingent items that arise from the movement of goods and that have a maturity of 3 months or less.

A System institution would be required to assign a 150-percent risk weight to an exposure to a foreign bank immediately upon determining that an event of sovereign default has occurred in the bank's home country, or if an event of sovereign default has occurred in the foreign bank's home country during the previous 5 years.

Both the Basel capital framework and our existing regulation treat exposures to securities firms that meet certain requirements like exposures to

⁶⁴ A depository institution is defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813(c)(1)). Under this proposal, a credit union refers to an insured credit union as defined under the Federal Credit Union Act (12 U.S.C. 1752(7)).

⁶⁵ § 615.5211(b)(16).

⁶⁶ Foreign bank means a foreign bank as defined in section 211.2 of the Federal Reserve Board's Regulation K (12 CFR 211.2), that is not a depository institution. For purposes of the proposal, home country meant the country where an entity is incorporated, chartered, or similarly established.

depository institutions.⁶⁷ However, like the Federal banking regulatory agencies, the FCA no longer believes that the risk profile of these firms is sufficiently similar to depository institutions to justify that treatment. Accordingly, the FCA proposes to require System institutions to treat exposures to securities firms as corporate exposures, with a 100-percent risk weight.

TABLE 4—RISK WEIGHTS FOR EXPOSURES TO FOREIGN BANKS

	Risk weight (in percent)
Sovereign CRC	
0–1	20
2	50
3	100
4–7	150
OECD Member with no CRC ...	20
Non-OECD Member with no CRC	100
Sovereign Default	150

5. Exposures to Public Sector Entities

The FCA's existing risk-based capital rules assign a 20-percent risk weight to general obligations of states and other political subdivisions of OECD countries.⁶⁸ Exposures that rely on repayment from specific projects (for example, revenue bonds) are assigned a risk weight of 50 percent. Other exposures to state and political subdivisions of OECD countries (including industrial revenue bonds) and exposures to political subdivisions of non-OECD countries receive a risk weight of 100 percent. The risk weights assigned to revenue obligations are higher than the risk weight assigned to general obligations because repayment of revenue obligations depends on specific projects, which present more risk relative to a general repayment obligation of a state or political subdivision of a sovereign.

The FCA is proposing to apply the same risk weights to exposures to U.S. states and municipalities as the existing risk-based capital rules apply. Under the proposal, these political subdivisions would be included in the definition of "public sector entity" (PSE). Consistent with both the current rules and the Basel capital framework, the FCA proposes to define a PSE as a state, local authority, or other governmental subdivision below the level of a sovereign. This definition would

⁶⁷ See § 615.5211(b)(14) and (b)(15).

⁶⁸ Political subdivisions of the United States would include 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.

include U.S. states and municipalities and would not include government-owned commercial companies that engage in activities involving trade, commerce, or profit that are generally conducted or performed in the private sector.

Under the proposal, a System institution would assign a 20-percent risk weight to a general obligation exposure to a PSE that is organized under the laws of the United States or any state or political subdivision thereof and a 50-percent risk weight to a revenue obligation exposure to such a PSE. A general obligation would be defined as a bond or similar obligation that is backed by the full faith and credit of a PSE. A revenue obligation would be defined as a bond or similar obligation that is an obligation of a PSE, but which the PSE is committed to repay with revenues from a specific project financed rather than general tax funds.

Similar to the Basel framework's use of home country risk weights to assign a risk weight to a PSE exposure, the FCA proposes to require a System institution to apply a risk weight to an exposure to a non-U.S. PSE based on (1) The CRC applicable to the PSE's home country or, if the home country has no CRC, whether it is a member of the OECD, and (2) whether the exposure is a general obligation or a revenue obligation, in accordance with Table 5.

The risk weights assigned to revenue obligations would be higher than the risk weights assigned to a general obligation issued by the same PSE, as set forth, for non-U.S. PSEs, in Table 5. Similar to exposures to a foreign bank, exposures to a non-U.S. PSE in a country that does not have a CRC rating would receive a 100-percent risk weight. Exposures to a non-U.S. PSE in a country that has defaulted on any outstanding sovereign exposure or that has defaulted on any sovereign exposure during the previous 5 years would receive a 150-percent risk weight. Table 5 illustrates the proposed risk weights for exposures to non-U.S. PSEs.

TABLE 5—PROPOSED RISK WEIGHTS FOR EXPOSURES TO NON-U.S. PSE GENERAL OBLIGATIONS AND REVENUE OBLIGATIONS
[in percent]

	Risk weight for exposures to non-U.S. PSE general obligations	Risk weight for exposures to non-U.S. PSE revenue obligations
Sovereign CRC: 0-1	20	50

TABLE 5—PROPOSED RISK WEIGHTS FOR EXPOSURES TO NON-U.S. PSE GENERAL OBLIGATIONS AND REVENUE OBLIGATIONS—Continued
[in percent]

	Risk weight for exposures to non-U.S. PSE general obligations	Risk weight for exposures to non-U.S. PSE revenue obligations
2	50	100
3	100	100
4-7	150	150
OECD Member with No CRC	20	50
Non-OECD Member with No CRC	100	100
Sovereign Default	150	150

The FCA proposes to allow a System institution to apply a risk weight to an exposure to a non-U.S. PSE according to the risk weight that the foreign banking organization supervisor allows to be assigned to it. In no event, however, may the risk weight for an exposure to a non-U.S. PSE be lower than the risk weight assigned to direct exposures to that PSE's home country.

6. Corporate Exposures

Under the FCA's existing risk-based capital rules, credit exposures to companies that are not depository institutions or securitization vehicles generally are assigned to the 100-percent risk weight category. A 20-percent risk weight is assigned to claims on, or guaranteed by, a securities firm incorporated in an OECD country that satisfies certain conditions.

The proposed requirements would be generally consistent with the existing risk-based capital rules and require System institutions to assign a 100-percent risk weight to all corporate exposures. The proposal would define a corporate exposure as an exposure to a company that is not an exposure to a sovereign, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, an MDB, a depository institution, a foreign bank, or a credit union, a PSE, a GSE, a residential mortgage exposure, an HVCRE exposure, a cleared transaction, a securitization exposure, an equity exposure, or an unsettled transaction. This definition captures all exposures that are not otherwise included in another specific exposure category and is not limited to exposures to corporations.

Accordingly, this category would include borrower loans such as agricultural loans and consumer loans, regardless of the corporate form of the borrower, unless those loans qualify for different risk weights (such as a 50-percent risk weight for residential mortgage exposures) under other provisions. This category would also include premises, fixed assets, and other real estate owned.

Because they are corporate exposures, this category includes all OFI exposures that do not qualify for the 20-percent depository institution risk weight provided in § 628.32(d) and discussed above. Our existing rules also contain a default 100-percent risk weight category.⁶⁹ But our existing regulations also contain an intermediate, 50-percent risk weight category for claims on OFIs that do not satisfy the requirements for a 20-percent risk weight but that otherwise meet similar capital, risk identification and control, and operational standards or that carry an investment grade credit rating.⁷⁰ Only if an OFI does not satisfy these standards does a claim on it receive a 100-percent risk weighting.

This 50-percent risk weighting for what would otherwise be a corporate exposure is inconsistent with our treatment of other corporate exposures. In addition, the Federal banking regulatory agencies would assign a 100-percent risk weight to these exposures. Accordingly, we propose to eliminate the 50-percent risk weight for OFIs and to assign a 100-percent risk weight to exposures to OFIs that do not satisfy the requirements for a 20-percent risk weight because they are not depository institutions.

We seek comment on our proposed capital treatment of exposures to OFIs. Specifically, what factors or other information would be relevant if we consider assigning an intermediate risk weight to a System institution's exposure to an OFI, recognizing that the same exposure to the same OFI would receive a 100-percent risk weight from a banking organization regulated by a Federal banking regulatory agency?

In contrast to the FCA's existing risk-based capital rules, all securities firms would be subject to the same treatment as corporate exposures.

7. Residential Mortgage Exposures

The FCA's existing risk-based capital rules assign "qualified residential loans" to the 50-percent risk-weight category.⁷¹ Qualified residential loans

⁶⁹ § 615.5211(d)(11).

⁷⁰ § 615.5211(c)(5).

⁷¹ § 615.5211(c)(2).

include both rural home loans authorized under § 613.3030 and single-family residential loans to bona fide farmers, ranchers, and producers and harvesters of aquatic products. Qualified residential loans must have been approved in accordance with prudent underwriting standards suitable for residential property and must not be past due 90 days or more or carried in nonaccrual status.⁷² If the loan does not satisfy these safety and soundness standards, or the property is not characteristic of residential property, the loan receives a 100-percent risk weight.

In general, although our rule is structured differently, our existing safety and soundness standards are very similar to the risk-weighting requirements of the Federal banking regulatory agencies for residential mortgage exposures.⁷³ The major differences between the two sets of rules are the FCA's criteria regarding the characteristics of residential property, which the Federal banking regulatory agencies do not have.

In the interest of consistency, we now propose to structure our rule the same way as the Federal banking regulatory agencies do. Moreover, we propose to adopt the safety and soundness standards of the Federal banking regulatory agencies. As mentioned above, and as discussed below, although these standards are already very similar, there would be a few changes to our rule. Finally, while we would retain two of our existing requirements regarding the characteristics of residential property, we propose to eliminate the rest of these requirements as unnecessary and burdensome.⁷⁴

We would define a residential mortgage exposure as an exposure (other than a securitization exposure or equity exposure) that is primarily secured by a first or subsequent lien on one-to-four family residential property, provided

⁷² See definition of *qualified residential loan* in § 615.5201. In addition to these credit risk standards, qualified residential loans must also satisfy a number of criteria designed to ensure that the property is residential in nature. The conditions for a loan to be considered nonaccrual are set forth in § 621.6(a) of the FCA's regulations. This rule proposes no changes to that provision.

⁷³ These agencies retained their existing risk-weighting requirements for residential mortgage exposures when they adopted their new capital rules.

⁷⁴ Although we are proposing to delete the specific requirements in this area, FCA examiners will continue to verify that residential property securing an exposure risk-weighted as a residential mortgage exposure does in fact exhibit characteristics of residential rather than agricultural property. If examiners determine that the property is agricultural in nature, they will require appropriate adjustment of the risk-based capital treatment.

that the dwelling (including attached components such as garages, porches, and decks) represents at least 50 percent of the total appraised value of the collateral secured by the first or subsequent lien.⁷⁵

The proposed rule would assign a residential mortgage exposure to the 50-percent risk-weight category if the property is either owner-occupied or rented⁷⁶ and if the exposure was made in accordance with prudent underwriting standards suitable for residential property, including standards relating to the loan amount as a percentage of the appraised value of the property;⁷⁷ is not 90 days or more past due or carried in non-accrual status; and is not restructured or modified.⁷⁸

A System institution must assign a 100-percent risk weight to all residential mortgage exposures that do not satisfy the criteria for a 50-percent risk weight.

The proposed rule would maintain the current risk-based capital treatment for residential mortgage exposures that are guaranteed by the U.S. Government or U.S. Government agencies. Accordingly, residential mortgage exposures that are unconditionally guaranteed by the U.S. Government or a U.S. Government agency would receive a 0-percent risk weight, and residential mortgage exposures that are conditionally guaranteed by the U.S. Government or a U.S. Government agency would receive a 20-percent risk weight.

Under the proposal, a residential mortgage exposure may be assigned to the 50-percent risk-weight category only if it is not restructured or modified. We believe this new restriction on System institution risk weighting, which the Federal banking regulatory agencies adopted, is appropriate based on risk.

However, a residential mortgage exposure modified or restructured on a permanent or trial basis solely pursuant to the U.S. Treasury's Home Affordable

⁷⁵ To ensure that the collateral is primarily residential rather than agricultural in nature, we propose to revise the definition adopted by the Federal banking regulatory agencies to include the requirement regarding the appraised value of the dwelling relative to the value of the collateral as a whole.

⁷⁶ The FCA's risk-weighting provisions would not expand the lending authorities of System institutions.

⁷⁷ The requirement that the underwriting standards be suitable for residential property is the other requirement we propose to add to ensure that the collateral is primarily residential rather than agricultural in nature.

⁷⁸ The FCA's existing regulation does not prohibit loans that have been restructured or modified from receiving a 50-percent risk weight. The other proposed requirements carry over from our existing regulation.

Mortgage Program (HAMP) would not be considered to be restructured or modified and would continue to receive a 50-percent risk weighting. Treating mortgage loans modified pursuant to HAMP in this manner is appropriate in light of the special and unique incentive features of HAMP, and the fact that the program is offered by the U.S. Government to achieve the public policy objective of promoting sustainable loan modifications for homeowners at risk of foreclosure in a way that balances the interests of borrowers, servicers, and lenders.⁷⁹

System institutions should be mindful that the residential mortgage market is likely to change in the future, in part because of regulations the CFPB is adopting to improve the quality of mortgage underwriting and to reduce the associated credit risk and in part for market-driven or other reasons. The FCA may propose changes in the treatment of residential mortgage exposures in the future. If so, we intend to take into consideration structural and product market developments, other relevant regulations, and potential issues with implementation across various product types.

8. High Volatility Commercial Real Estate Exposures

Certain acquisition, development, and construction (ADC) loans (which are a subset of commercial real estate exposures) present particular risks and warrant the holding of additional capital beyond the 100-percent risk weight that would otherwise apply. Accordingly, the FCA is proposing a 150-percent risk weight for these HVCRE exposures.

The proposed definition of HVCRE would be a credit facility that, prior to conversion to permanent financing, finances or has financed the acquisition, development, or construction of real property. The financing of four kinds of property is excluded from this definition:

- One-to-four family residential properties;
- Real property that the FCA has authorized as an investment pursuant to § 615.5140(e) (this provision authorizes System institutions to purchase and hold investments as approved by the FCA);
- The purchase or development of agricultural land, which includes all land known to be used or usable for

⁷⁹ The rules of the Federal banking regulatory agencies establish risk weights for "pre-sold residential construction loans" and "statutory multifamily mortgages." These are loans that are authorized by statutes that do not apply to System institutions, and therefore we do not propose risk weights for them.

agricultural purposes (such as crop and livestock production), provided that the valuation of the agricultural land is based on its value for agricultural purposes and the valuation does not take into consideration any potential use of the land for non-agricultural commercial development or residential development; or

- Commercial real estate projects that meet certain prudential criteria, including with respect to the LTV ratio and capital contributions or expense contributions of the borrower.

A commercial real estate loan that is not an HVCRE exposure, including permanent financing after the life of the ADC project concludes, would be treated as a corporate exposure.

There may be overlap between HVCRE exposures and exposures to land in transition—agricultural land in the path of development. FCA Bookletter BL-058 (BL-058) explains that while System institutions may finance land in transition, they may not provide development financing that converts agricultural land to non-agricultural land, except in very rare instances. BL-058 provides guidance on how a System institution making a loan to purchase or refinance land in transition should ensure compliance with the FCA's eligibility and scope of financing regulations. System institutions contemplating land in transition financing must review and understand BL-058 and must ensure they are in full compliance with all FCA regulations in that area.

9. Past Due Exposures

Under the FCA's existing risk-based capital rules, the risk weight of a loan does not change if the loan becomes past due, with the exception of certain residential mortgage loans. The FCA believes, however, that a higher risk weight is appropriate for past due exposures (such as past due agricultural or other borrower loans) to reflect the increased risk associated with such exposures.

To reflect the impaired credit quality of such exposures, the FCA proposes to require a System institution to assign a risk weight of 150 percent to an exposure that is not guaranteed or is not secured by financial collateral (and that is not a sovereign exposure or a residential mortgage exposure) if it is 90 days or more past due or recognized as nonaccrual.⁸⁰ We believe this risk weight is appropriate and that any increased capital burden, potential rise in procyclicality, or impact on lending

⁸⁰ A loan is considered nonaccrual if it meets any of the conditions specified in § 621.6(a).

associated with the increased risk weight is justified given the overall objective of capturing the risk associated with the impaired credit quality of these exposures.

Moreover, the increased risk weight would not double-count the risk of a past due exposure, even though the ALL would already be reflected in the risk-based capital numerator, because the ALL is intended to cover estimated, incurred losses as of the balance sheet date, not unexpected losses. The higher risk weight on past due exposures would ensure sufficient regulatory capital for the increased probability of unexpected losses on these exposures.

A System institution would be permitted to assign a risk weight to the portion of a past due exposure that is collateralized by financial collateral or that is guaranteed if the financial collateral, guarantee, or credit derivative meets the proposed requirements for recognition described in § 628.36 and § 628.37.⁸¹

10. Other Assets

Generally consistent with our existing risk-based capital rules, the FCA proposes the risk weights described below for the following exposures:

(1) A 0-percent risk weight to cash owned and held in all offices of the System institution, in transit, or in accounts at a depository institution or a Federal Reserve Bank; to gold bullion held in a depository institution's vaults on an allocated basis to the extent gold bullion assets are offset by gold bullion liabilities; and to exposures that arise from the settlement of cash transactions (such as equities, fixed income, spot foreign exchange and spot commodities) with a central counterparty where there is no assumption of ongoing counterparty credit risk by the central counterparty after settlement of the trade;

(2) A 20-percent risk weight to cash items in the process of collection; and

(3) A 100-percent risk weight to DTAs arising from temporary differences that a System institution could realize through net operating loss carrybacks;

(4) A 100-percent risk weight to all MSAs; and

(5) A 100-percent risk weight to all assets not specifically assigned a

⁸¹ As discussed below, proposed § 628.2 would define financial collateral as collateral in the form of, in pertinent part, cash, investment grade debt instruments that are not resecuritization exposures, publicly traded equity securities and convertible bonds, and mutual fund (including money market fund) shares if a price is publicly quoted daily, in which the System institution has a perfected, first-priority security interest (except for cash). Financial collateral would not include collateral such as real estate (whether agricultural or not) or chattel.

different risk weight under this proposed rule (other than exposures that would be deducted from tier 1 or tier 2 capital pursuant to proposed § 628.22).

As discussed above, the FCA is proposing, unlike the Federal banking regulatory agencies, to deduct from capital all DTAs, other than those arising from temporary differences that a System institution could realize through net operating loss carrybacks. In addition, because System institutions have such little exposure to MSAs, we are proposing to simplify the capital treatment as adopted by the Federal banking regulatory agencies. Accordingly, we are proposing to risk weight DTAs and MSAs as stated above and to eliminate the capital treatment, including the 250-percent risk weight, adopted by the Federal banking regulatory agencies.⁸²

11. Exposures to Other System Institutions

We propose to retain the existing 20-percent risk weight for loans from System banks to associations (direct loans).

Under proposed § 628.22(c), all equities (including preferred stock) a System institution has invested in another System institution would be deducted from the investing institution's regulatory capital, and therefore we do not propose a risk weighting for these exposures. These exposures would include an association's investment in its System bank, a System bank's purchase of nonvoting stock or participation certificates of an affiliated association pursuant to § 615.5171, and the purchase of a System association's preferred stock by a System bank, association, or service corporation pursuant to § 615.5175.

In the past, System institutions (generally System banks) have entered into loss-sharing agreements with other System institutions (generally, affiliated associations) under § 614.4340. In the future, if System institutions enter into a loss-sharing agreement, the FCA would assign a risk weight for any associated exposures at that time, using our reservation of authority.

12. Risk-Weighting for Specialized Exposures

By FCA Bookletter BL-052, dated January 25, 2006, the FCA permitted loans recorded before January 1, 2006 that are supported by Tobacco Buyout assignments to be risk weighted at 20

⁸² If a System institution were to increase significantly its exposures to MSAs, we would consider exercising our authority to require a higher risk weight.

percent.⁸³ These loans mature no later than 2015. Although we do not propose to include it in this rule, the FCA intends to continue to permit a 20-percent risk weight for these loans. If necessary, we will issue revised guidance on this capital treatment when we adopt our final capital rule.

By FCA Bookletter BL-053, dated February 27, 2007, the FCA permitted System institutions to assign a lower risk than would otherwise apply to certain electrical cooperative assets, based on the unique characteristics and lower risk profile of this industry segment. Exposures to certain electrical cooperative assets that satisfy specified conditions receive a 50-percent rather than a 100-percent risk weight. Furthermore, exposures to these assets receive a 20-percent risk weight if the assets have a AAA or AA credit rating.

We do not propose this favorable risk weighting for these assets in this rule, but we seek comment as to whether we should retain this risk weighting, being mindful of the Dodd-Frank Act section 939A requirement that we must eliminate the credit rating criteria. If we do retain this capital treatment, we will issue revised guidance on the risk weighting when we adopt our final capital rule.

C. Off-Balance Sheet Items

1. Credit Conversion Factors

Under this proposed rule, as under our existing risk-based capital rules, a System institution would calculate the exposure amount of an off-balance sheet item by multiplying the off-balance sheet component, which is usually the contractual amount, by the applicable credit conversion factor (CCF). This treatment would apply to off-balance sheet items, such as commitments (including a System bank's commitment to an association, discussed below), contingent items, guarantees, certain repo-style transactions, financial standby letters of credit, and forward agreements.

We propose to determine the exposure amount of a System bank's commitment to an association as the difference between the association's maximum credit limit with the System bank (as established by the general financing agreement or promissory note, as required by § 614.4125(d)) and the amount the association has borrowed from the System bank. For example, if a System bank has a \$100 maximum credit limit to an association and the association has \$80 outstanding on its direct note, the System bank's exposure

amount on its commitment would be \$20.

Determining a System bank's exposure amount in this manner would result in what could be viewed as double counting of commitment exposures (although, as discussed below, we disagree). Continuing the example above, the association that has borrowed \$80 from its System bank could have \$60 in outstanding loans to its borrowers and \$15 in commitments to its borrowers.⁸⁴ The System bank would be required to hold capital against its \$20 commitment exposure amount, and the association would be required to hold capital against its \$15 commitment exposure amount, which it would fund by drawing on its commitment with the System bank.

We do not believe this treatment results in double counting commitment exposures. This treatment is consistent with the way we treat loan exposures; we require a System bank to hold capital against the outstanding balance of its loan to an association, and we also require an association to hold capital against its loans to borrowers (even though the association's loaned funds come from its loan with the System bank). As with loan exposures, we believe that there are separate risks involved in System bank commitment exposures and association commitment exposures.⁸⁵ Accordingly, we do not propose to net association commitments against System bank commitments. We invite comment on this determination.

Similar to the current risk-based capital rules, a System institution would apply a 0-percent CCF to the unused portion of commitments that are unconditionally cancelable by the institution. For purposes of this proposed rule, a commitment would mean any legally binding arrangement that obligates a System institution to extend credit or to purchase assets. Unconditionally cancelable would mean a commitment that a System institution may, at any time, with or without cause, refuse to extend credit under the commitment (to the extent permitted under applicable law). In the case of an operating line of credit, a System institution would be deemed able to unconditionally cancel the commitment if it can, at its option, prohibit additional extensions of credit, reduce the credit line, and terminate the

commitment to the full extent permitted by applicable law. If a System institution provides a commitment that is structured as a syndication, it would only be required to calculate the exposure amount for its pro rata share of the commitment.

The FCA proposes to maintain the current 20-percent CCF for self-liquidating, trade-related contingencies with an original maturity of 14 months or less.⁸⁶ In addition, the FCA proposes to increase the CCF from 0 percent to 20 percent for commitments with an original maturity of 14 months or less that are not unconditionally cancelable by a System institution.

As under our existing risk-based capital rules, a System institution would apply a 50-percent CCF to commitments with an original maturity of more than 14 months that are not unconditionally cancelable by the institution and to transaction-related contingent items, including performance bonds, bid bonds, warranties, and performance standby letters of credit.

Under this proposed rule, a System institution would be required to apply a 100-percent CCF to off-balance sheet guarantees, repurchase agreements, credit-enhancing representations and warranties that are not securitization exposures, securities lending and borrowing transactions, financial standby letters of credit, forward agreements, and other similar exposures. The off-balance sheet component of a repurchase agreement would equal the sum of the current fair values of all positions the System institution has sold subject to repurchase. The off-balance sheet component of a securities lending transaction would be the sum of the current fair values of all positions the System institution has lent under the transaction. For securities borrowing transactions, the off-balance sheet component would be the sum of the current fair values of all non-cash positions the institution has posted as collateral under the transaction. In certain circumstances, a System institution may instead determine the exposure amount of the transaction as described in § 628.37 of the proposed rule.

⁸⁶ As under our existing rules, we propose a 14-month rather than a 12-month original maturity because the agricultural production cycle and related marketing efforts typically extend beyond 12 months. A 14-month maturity would allow a commitment for an operating loan to cover an entire cycle. A new commitment would be issued for the next cycle. Allowing a more favorable risk weight for a 14-month rather than a 12-month commitment does not materially raise risk in the portfolios of System institutions.

⁸³ Such loans recorded after this date must be risk-weighted at 100 percent.

⁸⁴ The association could use the \$5 difference to fund its operations and investments.

⁸⁵ To illustrate the difference, we note that an association could use money it borrows from the bank not only to establish and expand commitments and loans to borrowers but also to invest, hedge risk, replace equipment, or fund new facilities and services.

In contrast to our existing risk-based capital rules, which require capital for securities lending and borrowing transactions and repurchase agreements only if they generate an on-balance sheet exposure, the proposed rule would require a System institution to hold risk-based capital against all repo-style transactions (that is, repurchase agreements, reverse repurchase agreements, securities lending transactions, and securities borrowing transactions), regardless of whether they generate on-balance sheet exposures, as described in § 628.37 of the proposed rule. For example, capital is required against the cash receivable that a System institution generates when it borrows a security and posts cash collateral to obtain the security. We propose this approach because System institutions face counterparty credit risk when engaging in repo-style transactions, even if those transactions do not generate on-balance sheet exposures, and thus these transactions should not be exempt from risk-based capital requirements.

2. Credit-Enhancing Representations and Warranties

Consistent with our existing risk-based capital rules, under the proposed rule a System institution would be subject to a risk-based capital requirement when it provides credit-enhancing representations and warranties on assets sold or otherwise transferred to third parties, as such

positions are considered recourse arrangements.⁸⁷

A System institution would be required to hold capital only for the maximum contractual amount of its exposure under the representations and warranties, not against the value of the underlying loan. Moreover, a System institution would have to hold capital for the life of a credit-enhancing representation and warranty, but not after its expiration, regardless of the maturity of the underlying loan.

D. Over-the-Counter Derivative Contracts

Under the proposed rule, a System institution is required to hold risk-based capital for counterparty credit risk for an OTC derivative contract. As defined in proposed § 628.2, a derivative contract is a financial contract whose value is derived from the values of one or more underlying assets, reference rates, or indices of asset values or reference rates. A derivative contract includes interest rate, exchange rate, equity, commodity, credit, and any other derivative contract that poses similar counterparty credit risks. Derivative contracts also include unsettled securities, commodities, and foreign exchange transactions with a contractual settlement or delivery lag that is longer than the lesser of the market standard for the particular instrument or 5 business days. This applies, for example, to mortgage-backed securities (MBS) transactions

that the GSEs conduct in the To-Be-Announced market.

Under the proposed rule, an OTC derivative contract does not include a derivative contract that is a cleared transaction, which is subject to a specific treatment as described elsewhere in this preamble.

To determine the risk-weighted asset amount for an OTC derivative contract under the proposed rule, a System institution would first determine its exposure amount for the contract and then apply to that amount a risk weight based on the counterparty, eligible guarantor, or recognized collateral.

For a single OTC derivative contract that is not subject to a qualifying master netting agreement (as defined further below in this section), the proposed rule would require the exposure amount to be the sum of: (1) The System institution's current credit exposure, which would be the greater of the fair value or 0; and (2) potential future exposure (PFE), which would be calculated by multiplying the notional principal amount of the OTC derivative contract by the appropriate conversion factor, in accordance with Table 6 below.

Under the proposed rule, the conversion factor matrix would include the categories of OTC derivative contracts as illustrated in Table 6. For an OTC derivative contract that does not fall within one of the specified categories in Table 6, the proposed rule would require PFE to be calculated using the "other" conversion factor.

⁸⁷ §§ 615.5201 and 615.5210.

Table 6 - Conversion Factor Matrix For OTC Derivative Contracts¹

Remaining maturity ²	Interest rate	Foreign exchange rate and gold	Credit (investment-grade reference asset) ³	Credit (non-investment-grade reference asset)	Equity	Precious metals (except gold)	Other
1 year or less	0.00	0.01	0.05	0.10	0.06	0.07	0.10
Greater than 1 year and less than or equal to 5 years	0.005	0.05	0.05	0.10	0.08	0.07	0.12
Greater than 5 years	0.015	0.075	0.05	0.10	0.10	0.08	0.15

¹ For a derivative contract with multiple exchanges of principal, the conversion factor would be multiplied by the number of remaining payments in the derivative contract.

² For a derivative contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the fair value of the contract is 0, the remaining maturity would equal the time until the next reset date. For an interest rate derivative contract with a remaining maturity of greater than 1 year that meets these criteria, the minimum conversion factor would be 0.005.

³ A System institution would use the column labeled "Credit (investment-grade reference asset)" for a credit derivative whose reference asset is an outstanding unsecured long-term debt security without credit enhancement that is investment grade. A System institution would use the column labeled "Credit (non-investment-grade reference asset)" for all other credit derivatives. The proposed rule would define "investment grade" to mean that the entity to which the System institution is exposed through a loan or security, or the reference entity with respect to a credit derivative, has adequate capacity to meet financial commitments for the projected life of the asset or exposure. Such an entity or reference entity would have adequate capacity to meet financial commitments if the risk of its default is low and the full and timely repayment of principal and interest is expected.

For multiple OTC derivative contracts subject to a qualifying master netting agreement, a System institution would calculate the exposure amount by adding the net current credit exposure and the adjusted sum of the PFE amounts for all OTC derivative contracts subject to the qualifying master netting agreement. Under the proposed rule, the net current credit exposure would be the greater of 0 and the net sum of all positive and negative fair values of the individual OTC derivative contracts

subject to the qualifying master netting agreement. The adjusted sum of the PFE amounts would be calculated as described in § 628.34(a)(2)(ii) of the proposed rule.

Under the proposed rule, to recognize the netting benefit of multiple OTC derivative contracts, the contracts would have to be subject to a qualifying master netting agreement. The proposed rule would define a qualifying master netting agreement as any written, legally enforceable netting agreement that

creates a single legal obligation for all individual transactions covered by the agreement upon an event of default (including receivership, insolvency, liquidation, or similar proceeding) provided that certain conditions set forth in § 628.3 of the proposed rule are met.⁸⁸ These conditions include

⁸⁸ Section 628.3 of the proposed rule organizes substantive requirements related to cleared transactions, eligible margin loans, qualifying

requirements with respect to the System institution's right to terminate the contract and liquidate collateral and meeting certain standards with respect to legal review of the agreement to ensure it meets the criteria in the definition.

The required legal review must be sufficient so that the System institution may conclude with a well-founded basis that, among other things, the contract would be found legal, binding, and enforceable under the law of the relevant jurisdiction and that the contract meets the other requirements of the definition. In some cases, the legal review requirement could be met by reasoned reliance on a commissioned legal opinion or an in-house counsel analysis.

In other cases, for example, those involving certain unfamiliar derivative transactions or derivative counterparties in jurisdictions where a System institution has little experience, the institution would be expected to obtain an explicit, written legal opinion from external or internal legal counsel addressing the particular situation.

Under the proposed rule, if an OTC derivative contract is collateralized by financial collateral,⁸⁹ a System institution would first have to determine the exposure amount of the OTC derivative contract as described in this section of the preamble. Next, to recognize the credit risk mitigation benefits of the financial collateral, a System institution could use the simple approach for collateralized transactions as described in § 628.37(b) of the proposed rule. Alternatively, if the financial collateral is marked-to-market on a daily basis and subject to a daily margin maintenance requirement, a System institution could adjust the exposure amount of the contract using the collateral haircut approach described in § 628.37(c) of the proposed rule.

Similarly, if a System institution purchased a credit derivative that would be recognized under § 628.36 of the proposed rule as a credit risk mitigant, it would not be required to compute a

master netting agreements, and repo-style transactions in a central place to assist System institutions in determining their legal responsibilities.

⁸⁹ As discussed below, proposed § 628.2 would define financial collateral as collateral in the form of, in pertinent part, cash, investment grade debt instruments that are not resecuritization exposures, publicly traded equity securities and convertible bonds, and mutual fund (including money market fund) shares if a price is publicly quoted daily, in which the System institution has a perfected, first-priority security interest (except for cash). Financial collateral would not include collateral such as real estate (whether agricultural or not) or chattel.

separate counterparty credit risk capital requirement for the credit derivative, provided it does so consistently for all such credit derivative contracts. Further, where these credit derivative contracts are subject to a qualifying master netting agreement, the System institution would be required to either include them all or exclude them all from any measure used to determine the counterparty credit risk exposure to all relevant counterparties for risk-based capital purposes.

Under the proposed rule, a System institution would have to treat an equity derivative contract as an equity exposure and compute its risk-weighted asset amount according to the simple risk-weight approach (SRWA) described in § 628.52. If the System institution risk weighted a contract under the SRWA described in § 628.52, it could choose not to hold risk-based capital against the counterparty risk of the equity contract, so long as it made this choice for all such contracts. Where the OTC equity contracts are subject to a qualified master netting agreement, a System institution would either include or exclude all of the contracts from any measure used to determine counterparty credit risk exposures.⁹⁰

If a System provided protection through a credit derivative, it would have to treat the credit derivative as an exposure to the underlying reference asset and compute a risk-weighted asset amount for the credit derivative under § 628.32 of the proposed rule. The System institution would not be required to compute a counterparty credit risk capital requirement for the credit derivative, as long as it did so consistently for all such OTC credit derivative contracts. Further, where these credit derivative contracts are subject to a qualifying master netting agreement, the System institution would either have to include all or exclude all such credit derivatives from any measure used to determine counterparty credit risk exposure to all relevant counterparties for risk-based capital purposes.

Under the proposed rule, the risk weight for OTC derivative transactions is not subject to any specific ceiling, consistent with the Basel capital framework.

E. Cleared Transactions

Like the BCBS and the Federal banking regulatory agencies, the FCA supports incentives designed to encourage clearing of derivative and

⁹⁰ It would be unusual for a System institution to have such an exposure, but it could occur, for example, through foreclosure of collateral.

repo-style transactions⁹¹ through a central counterparty (CCP) wherever possible in order to promote transparency, multilateral netting, and robust risk management practices. Although there are some risks associated with CCPs, as discussed below, we believe that CCPs generally help improve the safety and soundness of the derivatives and repo-style transactions markets through the multilateral netting of exposures, establishment, and enforcement of collateral requirements, and the promotion of market transparency.

1. Definition of Cleared Transaction

Under the proposal, a System institution would be required to hold risk-based capital for all of its cleared transactions. In any such transaction, the System institution would act as a clearing member client (defined as a party to a cleared transaction associated with a CCP in which a clearing member acts either as a financial intermediary with respect to the party or guarantees the performance of the party to the CCP).⁹²

The proposed rule would define a cleared transaction as an exposure associated with an outstanding derivative contract or repo-style transaction that a System institution or clearing member has entered into with a CCP (that is, a transaction that a CCP has accepted).⁹³ Cleared transactions would include the following: (1) A transaction between a clearing member client System institution and a clearing member where the clearing member acts as a financial intermediary on behalf of the client and enters into an offsetting

⁹¹ See § 628.2 of the proposed rule for the definition of a repo-style transaction.

⁹² The Federal banking regulatory agencies adopted regulatory provisions contemplating that their regulated banking organizations could act as clearing members as well as clearing member clients. Because of the complexity, we believe System institutions will not want to act as clearing members, and we therefore do not propose comparable provisions. We invite comment as to whether we should adopt such provisions. In their absence, if a System institution did choose to act as a clearing member, we could address risk-weighting issues on a case-by-case basis.

⁹³ For example, we expect that a transaction with a derivatives clearing organization (DCO) would meet the proposed criteria for a cleared transaction. A DCO is a clearinghouse, clearing association, clearing corporation, or similar entity that enables each party to an agreement, contract, or transaction to substitute, through novation or otherwise, the credit of the DCO for the credit of the parties; arranges or provides, on a multilateral basis, for the settlement or netting of obligations; or otherwise provides clearing services or arrangements that mutualize or transfer credit risk among participants. To qualify as a DCO, an entity must be registered with the U.S. Commodity Futures Trading Commission and comply with all relevant laws and procedures.

transaction with a CCP; and (2) a transaction between a clearing member client System institution and a CCP where a clearing member guarantees the performance of the client to the CCP. Such transactions would also have to satisfy additional criteria provided in § 628.3 of the proposed rule, including bankruptcy remoteness of collateral, transferability criteria, and portability of the clearing member client's position.

Derivative transactions that are not cleared transactions because they do not meet all the criteria would be OTC derivative transactions. For example, if a transaction submitted to a CCP is not accepted by a CCP because the terms of the transaction submitted by the clearing members do not match or because other operational issues were identified by the CCP, the transaction would not meet the definition of a cleared transaction and would be an OTC derivative transaction. If the counterparties to the transaction resolved the issues and resubmitted the transaction and it was accepted, the transaction would then be a cleared transaction.

2. Risk Weighting for Cleared Transactions

Under the proposed rule, to determine the risk-weighted asset amount for a cleared transaction, a clearing member client System institution would multiply the trade exposure amount for the cleared transaction by the appropriate risk weight, determined as described below. The trade exposure amount would be calculated as follows:

(1) For a cleared transaction that is either a derivative contract or a netting set of derivative contracts, the trade exposure amount would equal the exposure amount for the derivative contract or netting set of derivative contracts, calculated using the current exposure method (CEM) for OTC derivative contracts (described in § 628.34 of the proposed rule), plus the fair value of the collateral posted by the clearing member client System institution and held by the CCP or clearing member in a manner that is not bankruptcy remote;⁹⁴ and

(2) For a cleared transaction that is a repo-style transaction or a netting set of repo-style transactions, the trade exposure amount would equal the exposure amount calculated under the collateral haircut approach (described in § 628.37(c) of the proposed rule) plus the fair value of the collateral posted by the clearing member client System institution that is held by the CCP or clearing member in a manner that is not bankruptcy remote.

The trade exposure amount would not include any collateral posted by a clearing member client System institution that is held by a custodian in a manner that is bankruptcy remote from the CCP, clearing member, other counterparties of the clearing member, and the custodian itself. In addition to the capital requirement for the cleared transaction, the System institution would remain subject to a capital requirement for any collateral provided to a CCP, a clearing member, or a custodian in connection with a cleared transaction in accordance with § 628.32 of the proposal.

The risk weight for a cleared transaction would depend on whether the CCP is a qualifying CCP (QCCP). Central counterparties that are designated financial market utilities (FMUs) and foreign entities regulated and supervised in a manner equivalent to designated FMUs would be QCCPs. In addition, a CCP could be a QCCP if it were in sound financial condition and met certain standards that are set forth in the proposed QCCP definition.

A System institution that is a clearing member client would apply a 2-percent risk weight to its trade exposure amount to a QCCP only if:

(1) The collateral posted by the clearing member client System institution 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; and

(2) The clearing member client System institution has conducted

sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review) that in the event of a legal challenge (including one resulting from default or a liquidation, insolvency, or receivership proceeding) the relevant court and administrative authorities would find the arrangements to be legal, valid, binding, and enforceable under the law of the relevant jurisdiction.

If the criteria above are not met, a clearing member client System institution would apply a risk weight of 4 percent to the trade exposure amount.

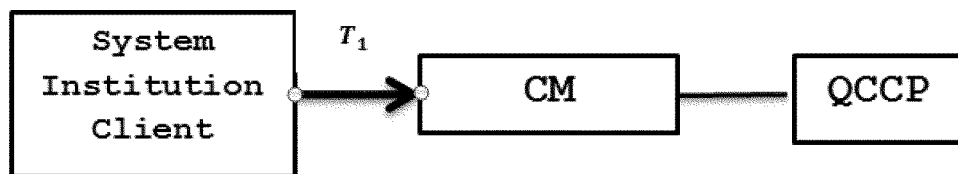
For a cleared transaction with a CCP that is not a QCCP, a clearing member client System institution would risk weight the trade exposure amount to the CCP according to the treatment for the CCP under § 628.32 of the proposal (generally 100 percent). Collateral posted by a clearing member client System institution that is held by a custodian in a manner that is bankruptcy remote from the CCP, clearing member, and other clearing member clients of the clearing member would not be subject to a capital requirement for counterparty credit risk.

The diagrams below demonstrate the various potential transactions and exposure treatment in the proposed rule. Table 7 sets out how the transactions illustrated in the diagrams below are risk-weighted under the proposed rule.

In the diagram, "T" refers to a transaction, and the arrow indicates the direction of the exposure. The diagram describes the appropriate risk weight treatment for exposures from the perspective of a System institution entering into cleared transactions as a client of a clearing member (T₁ and T₂). Table 7 shows for each trade whom the exposure is to, a description of the type of trade, and the risk weight that would apply based on the risk of the counterparty.

System Institution Client—Clearing Member(CM) Trade

- Financial Intermediary with offsetting transaction to QCCP



⁹⁴ Under this proposal, bankruptcy remote, with respect to an entity or asset, would mean that the

entity or asset would be excluded from an insolvent

entity's estate in a receivership, insolvency, or similar proceeding.

- Agency with guarantee of client performance

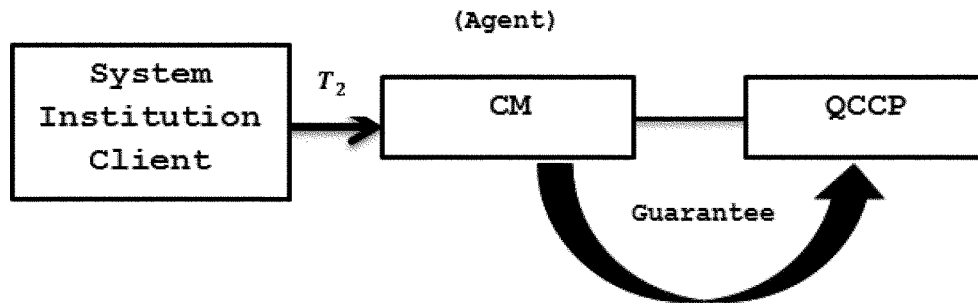


TABLE 7—RISK WEIGHTS FOR VARIOUS CLEARED TRANSACTIONS

T ₁	CM	CM financial intermediary with offsetting trade to QCCP.	2% or 4% risk weight on trade exposure amount.
T ₂	QCCP	CM agent with guarantee of client performance	2% or 4% risk weight on trade exposure amount.

F. Credit Risk Mitigation

System institutions use a number of techniques to mitigate credit risks. For example, a System institution may collateralize exposures with cash or securities; a third party may guarantee an exposure; a System institution may buy a credit derivative to offset an exposure’s credit risk; or a System institution may net exposures with a counterparty under a netting agreement. This section of the preamble describes how the proposed rule would allow System institutions to recognize the risk-mitigation effects of guarantees, credit derivatives, and collateral for risk-based capital purposes.

Under the proposed rule, a System institution generally would be able to use a substitution approach to recognize the credit risk mitigation effect of an eligible guarantee from an eligible guarantor and the simple approach to recognize the effect of collateral. To recognize credit risk mitigants, a System institution would have to implement operational procedures and risk-management processes that ensure that all documentation used in collateralizing or guaranteeing a transaction is legal, valid, binding, and enforceable under applicable law in the relevant jurisdictions. A System institution would be expected to conduct sufficient legal review to reach a well-founded conclusion that the documentation meets this standard as well as conduct additional reviews as necessary to ensure continuing enforceability.

Although the use of credit risk mitigants may reduce or transfer credit risk, it simultaneously may increase other risks, including operational, liquidity, or market risk. Accordingly, a

System institution would be expected to employ robust procedures and processes to control risks, including roll-off and concentration risks, and monitor and manage the implications of using credit risk mitigants for the institution’s overall credit risk profile.

1. Guarantees and Credit Derivatives
a. Eligibility Requirements

Our existing risk-based capital rules generally recognize third-party guarantees provided by central governments, GSEs, PSEs in the OECD countries, multilateral lending institutions and regional development banking organizations, U.S. depository institutions, foreign banks, and qualifying securities firms in OECD countries.⁹⁵ The FCA proposes to revise this listing of eligible guarantors to expressly include sovereigns, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, Federal Home Loan Banks (FHLB), Federal Agricultural Mortgage Corporation (Farmer Mac), MDBs, depository institutions, bank holding companies, savings and loan holding companies, credit unions, and foreign banks. Entities not expressly included in the above list would be eligible guarantors if they have issued and outstanding unsecured debt securities without credit enhancement that are investment grade, if their creditworthiness is not positively correlated with the credit risk of the exposures for which it has provided guarantees, and if they meet certain other requirements.⁹⁶

⁹⁵ Section 615.5211.

⁹⁶ Our proposed definition of eligible guarantor is comparable to that adopted by the Federal banking

regulatory agencies. A System institution would not satisfy the definition of eligible guarantor. System institutions are not included in the express listing of eligible guarantors. Moreover, individual System institutions do not meet the eligible guarantor criteria because of the positive correlation of the creditworthiness of a System institution with the credit risk of the System exposures for which it would provide guarantees. Accordingly, a System institution that received a guarantee from another System institution would not be able to recognize the guarantee for credit risk mitigation purposes.

Guarantees and credit derivatives would be required to meet specific eligibility requirements to be recognized for credit risk mitigation purposes. Under the proposal, an eligible guarantee would be defined as a guarantee from an eligible guarantor that is written and meets certain standards and conditions, including with respect to its enforceability. An eligible credit derivative would be defined as a credit derivative in the form of a credit default swap (CDS), nth-to-default swap, total return swap, or any other form of credit derivative approved by the FCA, provided that the instrument meets the standards and conditions set forth in the proposed definition. See the proposed definitions of “eligible guarantee” and “eligible credit derivative” in § 628.2 of the proposed rule.

Under this proposed rule, a System institution would be permitted to recognize the credit risk mitigation benefits of an eligible credit derivative that hedges an exposure that is different from the credit derivative’s reference exposure used for determining the derivative’s cash settlement value, deliverable obligation, or occurrence of a credit event if:

- (1) The reference exposure ranks *pari passu* with or is subordinated to the hedged exposure;

regulatory agencies. A System institution would not satisfy the definition of eligible guarantor. System institutions are not included in the express listing of eligible guarantors. Moreover, individual System institutions do not meet the eligible guarantor criteria because of the positive correlation of the creditworthiness of a System institution with the credit risk of the System exposures for which it would provide guarantees. Accordingly, a System institution that received a guarantee from another System institution would not be able to recognize the guarantee for credit risk mitigation purposes.

(2) The reference exposure and the hedged exposure are to the same legal entity; and

(3) Legally enforceable cross-default or cross-acceleration clauses are in place to assure payments under the credit derivative are triggered when the issuer fails to pay under the terms of the hedged exposure.

When a System institution has a group of hedged exposures with different residual maturities that are covered by a single eligible guarantee or eligible credit derivative, the System institution would treat each hedged exposure as if it were fully covered by a separate eligible guarantee or eligible credit derivative.

b. Substitution Approach

Under the proposed substitution approach, if the protection amount (as defined below) of an eligible guarantee or eligible credit derivative is greater than or equal to the exposure amount of the hedged exposure, a System institution would substitute the risk weight applicable to the guarantor or credit derivative protection provider for the risk weight assigned to the hedged exposure.

If the protection amount of the eligible guarantee or eligible credit derivative is less than the exposure amount of the hedged exposure, a System institution would treat the hedged exposure as two separate exposures (protected and unprotected) to recognize the credit risk mitigation benefit of the guarantee or credit derivative. In such cases, a System institution would calculate the risk-weighted asset amount for the protected exposure under § 628.36 of the proposed rule (using a risk weight applicable to the guarantor or credit derivative protection provider and an exposure amount equal to the protection amount of the guarantee or credit derivative). The System institution would calculate its risk-weighted asset amount for the unprotected exposure under § 628.32 of the proposed rule (using the risk weight assigned to the exposure and an exposure amount equal to the exposure amount of the original hedged exposure minus the protection amount of the guarantee or credit derivative).

The protection amount of an eligible guarantee or eligible credit derivative would mean the effective notional amount of the guarantee or credit derivative reduced to reflect any maturity mismatch, lack of restructuring coverage, or currency mismatch as described below. The effective notional amount for an eligible guarantee or eligible credit derivative would be the lesser of the contractual notional

amount of the credit risk mitigant or the exposure amount of the hedged exposure, multiplied by the percentage coverage of the credit risk mitigant. For example, the effective notional amount of a guarantee that covers, on a pro rata basis, 40 percent of any losses on a \$100 bond would be \$40.

c. Maturity Mismatch Haircut

Under the proposed requirements, a System institution that recognizes an eligible guarantee or eligible credit derivative would have to adjust the effective notional amount of the credit risk mitigant to reflect any maturity mismatch between the hedged exposure and the credit risk mitigant. A maturity mismatch occurs when the residual maturity of a credit risk mitigant is less than that of the hedged exposure(s).⁹⁷

The residual maturity of a hedged exposure would be the longest possible remaining time before the obligated party of the hedged exposure is scheduled to fulfill its obligation on the hedged exposure. A System institution would be required to take into account any embedded options that may reduce the term of the credit risk mitigant so that the shortest possible residual maturity for the credit risk mitigant would be used to determine the potential maturity mismatch. If a call is at the discretion of the protection provider, the residual maturity of the credit risk mitigant would be at the first call date. If the call is at the discretion of the System institution purchasing the protection, but the terms of the arrangement at origination of the credit risk mitigant contain a positive incentive for the institution to call the transaction before contractual maturity, the remaining time to the first call date would be the residual maturity of the credit risk mitigant. Under this proposed rule, a System institution would be permitted to recognize a credit risk mitigant with a maturity mismatch only if its original maturity is greater than or equal to 1 year and the residual maturity is greater than 3 months.

Assuming that the credit risk mitigant may be recognized, a System institution would be required to apply the following adjustment to reduce the

⁹⁷ As noted above, when a System institution has a group of hedged exposures with different residual maturities that are covered by a single eligible guarantee or eligible credit derivative, a System institution would treat each hedged exposure as if it were fully covered by a separate eligible guarantee or eligible credit derivative. To determine whether any of the hedged exposures has a maturity mismatch with the eligible guarantee or credit derivative, the System institution would assess whether the residual maturity of the eligible guarantee or eligible credit derivative is less than that of any of the hedged exposures.

effective notional amount of the credit risk mitigant to recognize the maturity mismatch:

$$P_m = E \times [(t - 0.25)/(T - 0.25)],$$

Where:

- (1) P_m = effective notional amount of the credit risk mitigant, adjusted for maturity mismatch;
- (2) E = effective notional amount of the credit risk mitigant;
- (3) t = the lesser of T or residual maturity of the credit risk mitigant, expressed in years; and
- (4) T = the lesser of 5 or the residual maturity of the hedged exposure, expressed in years.

d. Adjustment for Credit Derivatives Without Restructuring as a Credit Event

Under the proposal, a System institution that seeks to recognize an eligible credit derivative that does not include a restructuring of the hedged exposure as a credit event under the derivative would have to reduce the effective notional amount of the credit derivative recognized for credit risk mitigation purposes by 40 percent. For purposes of the proposed credit risk mitigation framework, a restructuring would involve forgiveness or postponement of principal, interest, or fees that result in a credit loss event (that is, a charge-off, specific provision, or other similar debit to the profit and loss account). In these instances, the System institution would be required to apply the following adjustment to reduce the effective notional amount of the credit derivative: $P_r = P_M \times 0.60$,

Where:

- (1) P_r = effective notional amount of the credit risk mitigant, adjusted for lack of a restructuring event (and maturity mismatch, if applicable); and
- (2) P_m = effective notional amount of the credit risk mitigant (adjusted for maturity mismatch, if applicable).

e. Currency Mismatch Adjustment

Under this proposal, if a System institution recognizes an eligible guarantee or eligible credit derivative that is denominated in a currency different from that in which the hedged exposure is denominated, the institution would apply the following formula to the effective notional amount of the guarantee or credit derivative:

$$P_c = P_r \times (1 - H_{fx}),$$

Where:

- (1) P_c = effective notional amount of the credit risk mitigant, adjusted for currency mismatch (and maturity mismatch and lack of restructuring event, if applicable);
- (2) P_r = effective notional amount of the credit risk mitigant (adjusted for

- maturity mismatch and lack of restructuring event, if applicable); and
- (3) H_{fx} = haircut appropriate for the currency mismatch between the credit risk mitigant and the hedged exposure.

A System institution would be required to use a standard supervisory haircut of 8 percent for H_{fx} (based on a 10-business day holding period and daily marking-to-market and remargining). The System institution is required to scale the haircut up using the square root of time formula if the institution revalues the guarantee or credit derivative less frequently than once every 10 business days. The applicable haircut H_M is calculated using the following square root of time formula:

$$H_M = 8\% \sqrt{\frac{T_M}{10}}, \text{ where}$$

T_m equals the greater of 10 or the number of days between revaluation.

f. Multiple Credit Risk Mitigants

If multiple credit risk mitigants cover a single exposure, a System institution would be able to disaggregate the exposure into portions covered by each credit risk mitigant (for example, the portion covered by each guarantee) and calculate separately a risk-based capital requirement for each portion. In addition, when a single credit risk mitigant covers multiple exposures, a System institution would have to treat each hedged exposure as covered by a single risk mitigant and must calculate separate risk-weighted asset amounts for each exposure using the substitution approach described in § 628.36(c) of the proposed rule.

2. Collateralized Transactions

a. Eligible Collateral

We propose to recognize a range of financial collateral as credit risk mitigants that may reduce the risk-based capital requirements associated with a collateralized transaction, similar to the Basel capital framework and the rules of the Federal banking regulatory agencies.

As proposed, financial collateral would mean collateral in the form of:

- (1) Cash on deposit at a depository institution, or Federal Reserve Bank (including cash held for the System institution by a third-party custodian or trustee);
- (2) Gold bullion;
- (3) Short- and long-term debt securities that are not resecuritization

exposures⁹⁸ and that are investment grade;

(4) Equity securities that are publicly traded;

(5) Convertible bonds that are publicly traded; or

(6) Money market fund shares and other mutual fund shares if a price for the shares is publicly quoted daily.⁹⁹ With the exception of cash on deposit at a depository institution, or Federal Reserve Bank, the System institution would also be required to have a perfected, first-priority security interest or, outside of the United States, the legal equivalent thereof, notwithstanding the prior security interest of any custodial agent. A System institution would be permitted to recognize partial collateralization of an exposure.

Under this proposed rule, a System institution would be able to recognize the risk-mitigating effects of financial collateral using the simple approach, described below, where: (1) The collateral is subject to a collateral agreement for at least the life of the exposure; (2) the collateral is revalued at least every 6 months; and (3) the collateral (other than gold) and the exposure are denominated in the same currency. For repo-style transactions, eligible margin loans, collateralized derivative contracts, and single-product netting sets of such transactions, a System institution could alternatively use the collateral haircut approach described below. A System institution would be required to use the same approach for similar exposures or transactions.

b. Risk Management Guidance for Recognizing Collateral

Before a System institution recognized collateral for credit risk mitigation purposes, it would have to: (1) Conduct sufficient legal review to ensure, at the inception of the collateralized transaction and on an ongoing basis, that all documentation used in the transaction is binding on all parties and legally enforceable in all relevant jurisdictions; (2) consider the correlation between risk of the underlying direct exposure and collateral risk in the transaction; and (3) fully take into account the time and cost needed to realize the liquidation

⁹⁸ References to resecuritization exposures in this preamble, and the presence of risk weights related to resecuritization exposures in this proposed rule, do not grant any authorities to System institutions related to resecuritization exposures.

⁹⁹ This definition of financial collateral would exclude collateral such as real estate or chattel. We note that publicly traded equity securities and convertible bonds are not eligible investments for System institutions, but they could be acquired as foreclosed collateral.

proceeds and the potential for a decline in collateral value over this time period.

A System institution also would have to ensure that the legal mechanism under which the collateral is pledged or transferred provides the institution the right to liquidate or take legal possession of the collateral in a timely manner in the event of the default, insolvency, or bankruptcy (or other defined credit event) of the counterparty and, where applicable, the custodian holding the collateral.

In addition, a System institution would have to ensure that it has:

(1) Taken all steps necessary to fulfill any legal requirements to secure its interest in the collateral so that it has and maintains an enforceable security interest;

(2) Set up and implemented clear and robust procedures to comply with any legal conditions required for declaring the default of the borrower and prompt liquidation of the collateral in the event of default;

(3) Established and implemented procedures and practices for conservatively estimating, on a regular ongoing basis, the fair value of the collateral, taking into account factors that could affect that value (for example, the liquidity of the market for the collateral and obsolescence or deterioration of the collateral); and

(4) Established systems in place for promptly requesting and receiving additional collateral for transactions whose terms require maintenance of collateral values at specified thresholds.

c. Simple Approach

Under the proposed simple approach, the collateralized portion of the exposure would receive the risk weight applicable to the collateral. The collateral would be required to meet the definition of financial collateral. For repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions, the collateral would be the instruments, gold, and cash that a System institution has borrowed, purchased subject to resale, or taken as collateral from the counterparty under the transaction. As noted above, in all cases:

(1) The collateral would have to be subject to a collateral agreement for at least the life of the exposure;

(2) The System institution would be required to revalue the collateral at least every 6 months; and

(3) The collateral (other than gold) and the exposure would be required to be denominated in the same currency.

Generally, the risk weight assigned to the collateralized portion of the exposure would be no less than 20

percent. However, OTC derivative contracts that are marked-to-fair value on a daily basis and subject to a daily margin maintenance agreement could receive:

- (1) A 0-percent risk weight to the extent that they are collateralized by cash on deposit; or
- (2) A 10-percent risk weight to the extent that the contracts are collateralized by an exposure to a sovereign that qualifies for a 0-percent risk weight under § 628.32 of the proposal.

In addition, a System institution may assign a 0-percent risk weight to the collateralized portion of an exposure where:

- (i) The financial collateral is cash on deposit; or
- (ii) The financial collateral is an exposure to a sovereign that qualifies for a 0-percent risk weight under § 628.32 of the proposal and the System institution has discounted the fair value of the collateral by 20 percent.

d. Collateral Haircut Approach

The proposed rule would permit a System institution to use a collateral haircut approach to recognize the credit risk mitigation benefits of financial collateral that secures an eligible margin loan, a repo-style transaction, collateralized derivative contract, or single-product netting set of such transactions.

To apply the collateral haircut approach, a System institution would determine the exposure amount and the relevant risk weight for the counterparty or guarantor.

The exposure amount for an eligible margin loan, repo-style transaction, collateralized derivative contract, or a netting set of such transactions is equal to the greater of 0 or the sum of the following three quantities:

- (1) The value of the exposure less the value of the collateral. For eligible

margin loans, repo-style transactions and netting sets thereof, the value of the exposure is the sum of the current fair values of all instruments, gold, and cash the System institution has lent, sold subject to repurchase, or posted as collateral to the counterparty under the transaction or netting set. For collateralized OTC derivative contracts and netting sets thereof, the value of the exposure is the exposure amount that is calculated under § 628.34 of the proposal. The value of the collateral would equal the sum of the current fair values of all instruments, gold and cash the System institution has borrowed, purchased subject to resale, or taken as collateral from the counterparty under the transaction or netting set;

(2) The absolute value of the net position in a given instrument or in gold (where the net position in a given instrument or in gold equals the sum of the current fair values of the instrument or gold the System institution has lent, sold subject to repurchase, or posted as collateral to the counterparty minus the sum of the current fair values of that same instrument or gold that the System institution has borrowed, purchased subject to resale, or taken as collateral from the counterparty) multiplied by the market price volatility haircut appropriate to the instrument or gold; and

(3) The absolute values of the net position of instruments and cash in a currency that is different from the settlement currency (where the net position in a given currency equals the sum of the current fair values of any instruments or cash in the currency the System institution has lent, sold subject to repurchase, or posted as collateral to the counterparty minus the sum of the current fair values of any instruments or cash in the currency the System institution has borrowed, purchased subject to resale, or taken as collateral

from the counterparty) multiplied by the haircut appropriate to the currency mismatch.

For purposes of the collateral haircut approach, a given instrument would include, for example, all securities with the same Committee on Uniform Securities Identification Procedures (CUSIP) number and would not include securities with different CUSIP numbers, even if issued by the same issuer with the same maturity date.

e. Standard Supervisory Haircuts

Under this proposed rule, a System institution would apply a haircut for price market volatility and foreign exchange rates, determined using standard supervisory market price volatility haircuts and a standard haircut for exchange rates.

The standard supervisory market price volatility haircuts would set a specified market price volatility haircut for various categories of financial collateral. These standard haircuts are based on the 10-business-day holding period for eligible margin loans and derivative contracts. For repo-style transactions, a System institution would multiply the standard supervisory haircuts by the square root of 1/2 to scale them for a holding period of 5 business days.

The FCA proposes standard supervisory market price volatility haircuts in accordance with Table 8 below. These haircuts reflect the collateral's credit quality and an appropriate differentiation based on the collateral's residual maturity.

A System institution would be required to use an 8-percent haircut for each currency mismatch for transactions subject to a 10-day holding period, as adjusted for different required holding periods.

TABLE 8—STANDARD SUPERVISORY MARKET PRICE VOLATILITY HAIRCUTS ¹

Residual maturity	Haircut (in percent) assigned based on:						Investment-grade securitization exposures (in percent)
	Sovereign issuers risk weight under § 628.32 ²			Non-sovereign issuers risk weight under § 628.32			
	Zero	20 or 50	100	20	50	100	
Less than or equal to 1 year	0.5	1.0	15.0	1.0	2.0	4.0	4.0
Greater than 1 year and less than or equal to 5 years	2.0	3.0	15.0	4.0	6.0	8.0	12.0
Greater than 5 years	4.0	6.0	15.0	8.0	12.0	16.0	24.0
Main index equities (including convertible bonds) and gold	15.0						
Other publicly traded equities (including convertible bonds)	25.0						
Mutual funds	Highest haircut applicable to any security in which the fund can invest.						

TABLE 8—STANDARD SUPERVISORY MARKET PRICE VOLATILITY HAIRCUTS ¹—Continued

Residual maturity	Haircut (in percent) assigned based on:						Investment-grade securitization exposures (in percent)
	Sovereign issuers risk weight under § 628.32 ²			Non-sovereign issuers risk weight under § 628.32			
	Zero	20 or 50	100	20	50	100	
Cash collateral held	0						
Other exposure types	25.0						

¹ The market price volatility haircuts in Table 8 are based on a 10-business-day holding period.

² Includes a foreign PSE that receives a 0-percent risk weight.

The proposed rule would require that a System institution increase the standard supervisory haircut for transactions involving large netting sets. During the financial crisis, many financial institutions experienced significant delays in settling or closing out collateralized transactions, such as repo-style transactions and collateralized OTC derivatives.

Accordingly, for netting sets where:

- (1) The number of trades exceeds 5,000 at any time during the quarter;¹⁰⁰
- (2) One or more trades involves illiquid collateral posted by the counterparty; or

(3) The netting set includes any OTC derivatives that cannot be easily replaced, this proposed rule would require a System institution to assume a holding period of 20 business days for the collateral under the collateral haircut approach. The formula and methodology for increasing the haircut to reflect this longer holding period is described in § 628.37(c) of the proposed rule. A System institution is not required to adjust the holding period upward for cleared transactions. When determining whether collateral is illiquid or an OTC derivative cannot be easily replaced for these purposes, a System institution should assess whether, during a period of stressed market conditions, it could obtain multiple price quotes within 2 days or less for the collateral or OTC derivative that would not move the market or represent a market discount (in the case of collateral) or a premium (in the case of an OTC derivative.)

In addition, the proposed rule would require a System institution to increase the holding period for a netting set if over the two previous quarters more than two margin disputes on a netting set have occurred that lasted longer than the holding period.

Margin disputes may occur when the System institution and its counterparty

do not agree on the value of collateral or on the eligibility of the collateral provided. Margin disputes also can occur when the System institution and its counterparty disagree on the amount of margin that is required, which could result from differences in the valuation of a transaction, or from errors in the calculation of the net exposure of a portfolio, for instance, if a transaction is incorrectly included or excluded from the portfolio.

The determination as to whether a dispute constitutes a margin dispute for purposes of this rule would depend on whether resolution of the dispute occurs within the time period required under an agreement. Where a dispute is subject to a recognized industry dispute resolution protocol, the dispute period would be considered to begin after a third-party dispute resolution mechanism has failed.

A System institution would not be required to adjust the holding period upward for cleared transactions.

f. Own Estimates of Haircuts

Unlike the Federal banking regulatory agencies, the FCA does not propose to permit System institutions to calculate market price volatility and foreign exchange volatility using their own internal estimates. We believe, due to the complexity of developing and using these estimates, that no System institution is likely to use its own estimates of haircuts. We seek comment on whether we should adopt a regulation that would permit the use of an institution's own estimates. We note that even if we do not adopt such a provision, we would be able to permit a System institution to use its own estimates in the future on a case-by-case basis, using standards similar to those contained in the final rule of the Federal banking regulatory agencies.¹⁰¹

¹⁰¹ The final rules of the Federal banking regulatory agencies permit a banking organization to use such haircuts only after satisfying specified minimum standards and receiving prior approval from its primary Federal supervisor.

G. Unsettled Transactions

The FCA proposes to provide for a separate risk-based capital requirement for transactions involving securities, foreign exchange instruments, and commodities that have a risk of delayed settlement or delivery. The proposed capital requirement would not, however, apply to certain types of transactions, including:

- (1) Cleared transactions that are marked-to-market daily and subject to daily receipt and payment of variation margin;
- (2) Repo-style transactions, including unsettled repo-style transactions;
- (3) One-way cash payments on OTC derivative contracts; or
- (4) Transactions with a contractual settlement period that is longer than the normal settlement period (which the proposal defines as the lesser of the market standard for the particular instrument or 5 business days).¹⁰²

Under the proposal, in the case of a system-wide failure of a settlement, clearing system, or central counterparty, the FCA may waive risk-based capital requirements for unsettled and failed transactions until the situation is rectified.

This rule proposes separate treatments for delivery-versus-payment (DvP) and payment-versus-payment (PvP) transactions with a normal settlement period, and non-DvP/non-PvP transactions with a normal settlement period. A DvP transaction would refer to a securities or commodities transaction in which the buyer is obligated to make payment only if the seller has made delivery of the securities or commodities and the seller is obligated to deliver the securities or commodities only if the buyer has made payment. A PvP transaction would mean a foreign exchange transaction in which each counterparty is obligated to make a final transfer of one or more currencies only if the other counterparty

¹⁰² Such transactions would be treated as derivative contracts as provided in § 628.34 or § 628.35 of the proposal.

¹⁰⁰ The 5,000-trade threshold applies to a netting set, which by definition means a group of transactions with a single counterparty that are subject to a qualifying master netting agreement.

has made a final transfer of one or more currencies.

A System institution would be required to hold risk-based capital against a DvP or PVP transaction with a normal settlement period if the institution's counterparty has not made delivery or payment within 5 business days after the settlement date. The System institution would determine its risk-weighted asset amount for such a transaction by multiplying the positive current exposure of the transaction for the institution by the appropriate risk weight in Table 9. The positive current exposure from an unsettled transaction of a System institution would be the difference between the transaction value at the agreed settlement price and the current market price of the transaction, if the difference results in a credit exposure of the institution to the counterparty.

TABLE 9—PROPOSED RISK WEIGHTS FOR UNSETTLED DVP AND PVP TRANSACTIONS

Number of business days after contractual settlement date	Risk weight to be applied to positive current exposure (in percent)
From 5 to 15	100.0
From 16 to 30	625.0
From 31 to 45	937.5
46 or more	1,250.0

A System institution would hold risk-based capital against any non-DvP/non-PvP transaction with a normal settlement period if the institution delivered cash, securities, commodities, or currencies to its counterparty but has not received its corresponding deliverables by the end of the same business day. The System institution would continue to hold risk-based capital against the transaction until it has received the corresponding deliverables. From the business day after the System institution has made its delivery until 5 business days after the counterparty delivery is due, the institution would calculate the risk-weighted asset amount for the transaction by risk weighting the current fair value of the deliverables owed to the institution, using the risk weight appropriate for an exposure to the counterparty in accordance with § 628.32. If a System institution has not received its deliverables by the 5th business day after the counterparty delivery due date, the institution would assign a 1,250-percent risk weight to the current fair value of the deliverables owed.

H. Risk-Weighted Assets for Securitization Exposures

Under the FCA's existing risk-based capital rules, a System institution may use external ratings issued by NRSROs to assign risk weights to certain recourse obligations, residual interests, direct credit substitutes, and asset-backed securities (ABS) and MBS. We propose to significantly revise the risk-based capital framework for securitization exposures. These proposed revisions include removing references to and reliance on credit ratings to determine risk weights for these exposures and using alternative standards of creditworthiness, as required by section 939A of the Dodd-Frank Act. In addition, we propose to update the terminology for the securitization framework, include a definition of a securitization exposure that encompasses a wider range of exposures with similar risk characteristics, and implement new due diligence requirements for securitization exposures.

1. Overview of the Securitization Framework and Definitions

The proposed securitization framework is designed to address the credit risk of exposures that involve the tranching of the credit risk of one or more underlying financial exposures.¹⁰³ The proposed rule would define a securitization exposure as an on- or off-balance sheet credit exposure (including credit-enhancing representations and warranties) that arises from a traditional or synthetic securitization (including a resecuritization), or an exposure that directly or indirectly references a securitization exposure.

A traditional securitization would be defined, in part, as a transaction in which credit risk of one or more underlying exposures has been transferred to one or more third parties (other than through the use of credit derivatives or guarantees), where the credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority. The proposed definition includes certain other conditions, such as requiring all or substantially all of the

underlying exposures to be financial exposures.

Both the designation of exposures as securitization exposures (or resecuritization exposures, as described below) and the calculation of risk-based capital requirements for securitization exposures under the proposed rule are guided by the economic substance of a transaction rather than its legal form. Provided there is tranching of credit risk, securitization exposures could include, among other things, ABS and MBS, loans, lines of credit, liquidity facilities, financial standby letters of credit, credit derivatives and guarantees, loan servicing assets, servicer cash advance facilities, reserve accounts, credit-enhancing representations and warranties, and credit-enhancing interest-only strips (CEIOs). Securitization exposures would also include assets sold with retained tranches.

Requiring all or substantially all of the underlying exposures of a securitization to be financial exposures creates an important boundary between the general credit risk framework and the securitization framework. Examples of financial exposures include loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, MBS, other debt securities, or equity securities. Based on their cash flow characteristics, for purposes of this proposal, asset classes such as lease residuals and royalty income would also be considered financial assets.

The securitization framework is designed to address the tranching of the credit risk of financial exposures and is not designed, for example, to apply to tranching credit exposures to commercial or industrial companies or nonfinancial assets or to amounts deducted from capital in § 628.22 of the proposal. In other words, a loan backed by nonfinancial assets (such as facilities, objects, or commodities that are being financed), even if the credit exposure is tranching, would not be a securitization exposure.

Under the proposal, an operating entity would not fall under the definition of a traditional securitization (even if substantially all of its assets are financial exposures). For purposes of the proposed definition of a traditional securitization, operating entities generally would refer to companies that are established to conduct business with clients with the intention of earning a profit in their own right and that generally produce goods or provide services beyond the business of investing, reinvesting, holding, or

¹⁰³ Only those MBS that involve tranching of credit risk would be securitization exposures. As discussed below, mortgage-backed pass-through securities (for example, those guaranteed by Freddie Mac or Fannie Mae) that feature various maturities but do not involve tranching of credit risk would not meet the proposed definition of a securitization exposure. These securities are risk weighted in accordance with the general risk-weighting provisions.

trading in financial assets.¹⁰⁴ Under the proposal, a System institution's equity investment in an operating entity generally would be an equity exposure.¹⁰⁵ However, investment firms that generally do not produce goods or provide services beyond the business of investing, reinvesting, holding, or trading in financial assets, would not be operating entities for purposes of this proposal and would not qualify for this general exclusion from the definition of traditional securitization.

Paragraph (10) of the proposed definition of traditional securitization (in § 628.2) would specifically exclude exposures to investment funds (as defined in the proposed rule), collective investment funds, and pension plans (both terms as defined in relevant regulations set forth in the proposed definition); and exposures that are registered with the SEC under the Investment Company Act of 1940 or foreign equivalents. These specific exemptions serve to narrow the potential scope of the securitization framework. These entities and transactions are exempted because they are regulated and subject to strict leverage requirements. The capital requirements for an extension of credit to, or an equity holding in, these entities and transactions are more appropriately calculated under the rules for corporate and equity exposures.

To address the treatment of investment firms that are not specifically excluded from the securitization framework, the proposed rule provides discretion to the FCA to exclude from the definition of a traditional securitization those transactions in which the underlying exposures are owned by an investment firm that exercises substantially unfettered control over the size and composition of its assets, liabilities, and off-balance sheet exposures.

In determining whether to exclude an investment firm from the securitization framework, the FCA would consider a number of factors, including the assessment of the transaction's leverage, risk profile, and economic substance. This supervisory exclusion would give the FCA discretion to distinguish structured finance transactions, to which the securitization framework was

designed to apply, from those of flexible investment firms such as certain hedge funds and private equity funds.

Only investment firms that can easily change the size and composition of their capital structure, as well as the size and composition of their assets and off-balance sheet exposures, would be eligible for the exclusion from the definition of traditional securitization under this provision. The FCA does not consider managed collateralized debt obligation vehicles, structured investment vehicles, and similar structures, which allow considerable management discretion regarding asset composition but are subject to substantial restrictions regarding capital structure, to have substantially unfettered control. Thus, such transactions would meet the definition of traditional securitization.

The line between securitization exposures and non-securitization exposures may be difficult to draw in some circumstances. In addition to the supervisory exclusion from the definition of traditional securitization described above, the FCA may expand the scope of the securitization framework to include other transactions if doing so is justified by the economics of the transaction. Similar to the analysis for excluding an investment firm from treatment as a traditional securitization, the FCA would consider the economic substance, leverage, and risk profile of transactions to ensure the appropriate risk-based capital treatment. The FCA would consider a number of factors when assessing the economic substance of a transaction including, for example, the amount of equity in the structure, overall leverage (whether on- or off-balance sheet), whether redemption rights attach to the equity investor, and the ability of the junior tranches to absorb losses without interrupting contractual payments to more senior tranches.

Under the proposal, a synthetic securitization would mean a transaction in which:

(1) All or a portion of the credit risk of one or more underlying exposures is retained or transferred to one or more third parties through the use of one or more credit derivatives or guarantees (other than a guarantee that transfers only the credit risk of an individual retail exposure);

(2) The credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority;

(3) Performance of the securitization exposures depends upon the performance of the underlying exposures; and

(4) All or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, MBS, other debt securities, or equity securities).

Mortgage-backed pass-through securities (for example, those guaranteed by Freddie Mac or Fannie Mae) that feature various maturities but do not involve tranching of credit risk would not meet the proposed definition of a securitization exposure. Only those MBS that involve tranching of credit risk would be securitization exposures.

This proposed rule would define a resecuritization exposure as an on- or off-balance sheet exposure to a resecuritization; or an exposure that directly or indirectly references a resecuritization exposure. A resecuritization would mean a securitization which has more than one underlying exposure and in which one or more of the underlying exposures is a securitization exposure. A resecuritization would not include exposures comprised of a single asset that has been retransched, such as a resecuritization of a real estate mortgage investment conduit (Re-REMIC). A resecuritization also would not include pass-through securities that have been pooled together and effectively reissued as tranching securities, because the pass-through securities do not tranche credit protection and would therefore not be considered securitization exposures.

In their rules, the Federal banking regulatory agencies excluded certain exposures to asset-backed commercial paper (ABCP) programs from the definition of resecuritization exposure. Their rules defined an ABCP program as a program established primarily for the purpose of issuing commercial paper that is investment grade and backed by underlying exposures held in a bankruptcy-remote special purpose entity. The System has access to the capital markets through the Funding Corporation; we believe it unlikely that a System institution would establish an ABCP program, because if the Funding Corporation's ability to issue debt ever was impeded, we believe the ability of an ABCP program to issue commercial paper would face the same difficulties. Accordingly, in the interest of simplifying our regulations where possible, we propose to make no reference to ABCP programs. We seek comment as to whether we should include provisions in our risk-based capital rules regarding ABCP programs that are comparable to those adopted by the Federal banking regulatory agencies.

¹⁰⁴ Under this definition, all System banks, associations, and service corporations, and all UBEs, are operating entities and are not traditional securitizations.

¹⁰⁵ A System institution's equity investment in an operating entity that is another System institution (a System bank, association, or service corporation), however, would be deducted from capital pursuant to § 628.22 rather than being risk weighted as an equity exposure.

2. Operational Requirements

a. Due Diligence Requirements

The FCA, like the Federal banking regulatory agencies, notes that during the recent financial crisis, many banking organizations relied exclusively on NRSRO ratings and did not perform their own credit analysis of the securitization exposures.¹⁰⁶ As the Federal banking regulatory agencies have required in their rules, we propose that System institutions satisfy specific due diligence requirements for securitization exposures. Specifically, a System institution would be required to demonstrate, to the FCA's satisfaction, a comprehensive understanding of the features of a securitization exposure that would materially affect the exposure's performance. The System institution's analysis would be required to be commensurate with the complexity of the exposure and the materiality of the exposure in relation to capital of the institution. On an on-going basis (no less frequently than quarterly), the System institution would be required to evaluate, review, and update as appropriate the analysis required under § 628.41(c)(1) of the proposed rule for each securitization exposure. The pre- and periodic post-acquisition analysis of the exposure's risk characteristics would have to consider:

(1) Structural features of the securitization that would materially affect the performance of the exposure, for example, the contractual cash flow waterfall, waterfall-related triggers, credit enhancements, liquidity enhancements, fair value triggers, the performance of organizations that service the position, and deal-specific definitions of default;

(2) Relevant information regarding the performance of the underlying credit exposure(s), for example, the percentage of loans 30, 60, and 90 days past due; default rates; prepayment rates; loans in foreclosure; property types; occupancy; average credit score or other measures of creditworthiness; average LTV ratio; and industry and geographic diversification data on the underlying exposure(s);

(3) Relevant market data on the securitization, for example, bid-ask spread, most recent sales price and historical price volatility, trading volume, implied market rating, and size, depth and concentration level of the market for the securitization; and

(4) For resecuritization exposures, performance information on the underlying securitization exposures, for example, the issuer name and credit quality, and the characteristics and

performance of the exposures underlying the securitization exposures.

If the System institution is not able to meet these due diligence requirements and demonstrate a comprehensive understanding of a securitization exposure to the FCA's satisfaction, the institution would be required to assign a risk weight of 1,250 percent to the exposure.

b. Operational Requirements for Traditional Securitizations

In a traditional securitization, an originating banking organization typically transfers a portion of the credit risk of underlying exposures (such as loans) to third parties by selling those exposures to a third party (which could include, but is not limited to, a securitization special purpose entity).¹⁰⁷ The proposed rule would define "originating System institution," with respect to a securitization, as a System institution that directly or indirectly originated the underlying exposures included in a securitization.¹⁰⁸

Under the proposed rule, a System institution that transfers exposures it has originated or purchased to a third party in connection with a traditional securitization can exclude the underlying exposures from the calculation of risk-weighted assets only if each of the following conditions are met: (1) The exposures are not reported on the System institution's consolidated balance sheet under GAAP; (2) the System institution has transferred to one or more third parties credit risk associated with the underlying exposures; and (3) any clean-up calls relating to the securitization are eligible clean-up calls (as discussed below).

An originating System institution that meets these conditions must hold risk-based capital against any credit risk it retains or acquires in connection with the securitization. An originating System institution that fails to meet these conditions is required to hold risk-based capital against the transferred exposures as if they had not been securitized and must deduct from CET1

¹⁰⁷ The proposal would define a securitization SPE as a corporation, trust, or other entity organized for the specific purpose of holding underlying exposures of a securitization, the activities of which are limited to those appropriate to accomplish this purpose, and the structure of which is intended to isolate the underlying exposures held by the entity from the credit risk of the seller of the underlying exposures to the entity.

¹⁰⁸ Note that in the definition of originating System institution, "originating" refers to originating the underlying exposures (such as loans) that are included in a securitization, not to originating the securitization. We remind System institutions that nothing in these capital rules authorizes them to engage in activities that are not otherwise authorized.

capital any after-tax gain-on-sale resulting from the transaction.

In addition, if a securitization: (1) Includes one or more underlying exposures in which the borrower is permitted to vary the drawn amount within an agreed limit under a line of credit; and (2) contains an early amortization provision, the originating System institution is required to hold risk-based capital against the transferred exposures as if they had not been securitized and deduct from CET1 capital any after-tax gain-on-sale resulting from the transaction.¹⁰⁹ We believe that this treatment is appropriate given the lack of risk transference in securitizations of revolving underlying exposures with early amortization provisions.

c. Operational Requirements for Synthetic Securitizations

System institutions are authorized to use synthetic securitizations as risk management tools to reduce their overall credit risk exposure relating to certain referenced loan pools. The use of synthetic securitizations enables System institutions to increase their risk-based capital ratios without moving assets off their balance sheets.

For synthetic securitizations, an originating System institution would recognize for risk-based capital purposes the use of a credit risk mitigant to hedge underlying exposures only if each of the conditions in the proposed definition of "synthetic securitization" is satisfied.

Failure to meet these operational requirements for a synthetic securitization would prevent a System institution that has purchased tranch

¹⁰⁹ Many securitizations of revolving credit facilities contain provisions that require the securitization to be wound down and investors to be repaid if the excess spread falls below a certain threshold. This decrease in excess spread may, in some cases, be caused by deterioration in the credit quality of the underlying exposures. An early amortization event could increase a System institution's capital needs if new draws on the revolving credit facilities need to be financed by the System institution using on-balance sheet sources of funding. The payment allocations used to distribute principal and finance charge collections during the amortization phase of these transactions also could expose a System institution to a greater risk of loss than in other securitization transactions. The proposed rule would define an early amortization provision as a provision in a securitization's governing documentation that, when triggered, causes investors in the securitization exposures to be repaid before the original stated maturity of the securitization exposure, unless the provision: (1) Is solely triggered by events not related to the performance of the underlying exposures or the originating System institution (such as material changes in tax laws or regulations); or (2) leaves investors fully exposed to future draws by borrowers on the underlying exposures even after the provision is triggered.

credit protection referencing one or more of its exposures from using the proposed securitization framework with respect to the reference exposures and would require the institution to hold risk-based capital against the underlying exposures as if they had not been synthetically securitized.

A System institution that holds a synthetic securitization as a result of purchasing credit protection may use the securitization framework to determine the risk-based capital for its exposure. Alternatively, it may instead choose to disregard the credit protection and use the general risk weights under § 628.32.

A System institution that provides tranching credit protection in the form of a synthetic securitization or credit protection to a synthetic securitization must use the securitization framework to compute risk-based capital requirements for its exposures to the synthetic securitization even if the originating System institution fails to meet one or more of the operational requirements for a synthetic securitization.

d. Clean-Up Calls

To satisfy the operational requirements for securitizations and enable an originating System institution to exclude the underlying exposures from the calculation of its risk-based capital requirements, any clean-up call associated with a securitization would need to be an eligible clean-up call. The proposal would define a clean-up call as a contractual provision that permits an originating System institution or servicer to call securitization exposures before their stated maturity or call date. In the case of a traditional securitization, a clean-up call generally is accomplished by repurchasing the remaining securitization exposures once the amount of underlying exposures or outstanding securitization exposures falls below a specified level. In the case of a synthetic securitization, the clean-up call may take the form of a clause that extinguishes the credit protection once the amount of underlying exposures has fallen below a specified level.

Under the proposal, an eligible clean-up call would be a clean-up call that:

- (1) Is exercisable solely at the discretion of the originating System institution or servicer;
- (2) Is not structured to avoid allocating losses to securitization exposures held by investors or otherwise structured to provide credit enhancement to the securitization (for example, to purchase non-performing underlying exposures); and

(3) For a traditional securitization, is only exercisable when 10 percent or less of the principal amount of the underlying exposures or securitization exposures (determined as of the inception of the securitization) is outstanding; or, for a synthetic securitization, is only exercisable when 10 percent or less of the principal amount of the reference portfolio of underlying exposures (determined as of the inception of the securitization) is outstanding.

Where a securitization SPE is structured as a master trust, a clean-up call with respect to a particular series or tranche issued by the master trust would meet criterion (3) of the definition of “eligible clean-up call” as long as the outstanding principal amount in that series was 10 percent or less of its original amount at the inception of the series.

3. Risk-Weighted Asset Amounts for Securitization Exposures

Under the proposed securitization framework, a System institution generally would calculate a risk-weighted asset amount for a securitization exposure by applying either: (1) The simplified supervisory formula approach (SSFA), described elsewhere in this preamble; or (2) a gross-up approach. A System institution would be required to apply either the gross-up approach or the SSFA consistently across all of its securitization exposures. However, a System institution could choose to apply a 1,250-percent risk weight to any securitization exposure. While the FCA does not propose to restrict the ability of System institutions to switch from the SSFA to the gross-up approach, we do not anticipate there should be a need for frequent changes in methodology by an institution absent significant change in the nature of its securitization activities, and we would expect institutions would be able to provide the FCA’s Office of Examination, upon request, with their rationale for changing methodologies.

The SSFA may be somewhat complex for some System institutions to use, although it might also result in lower risk-weighting requirements. The gross-up approach may involve less operational burden, but it may also result in higher risk-weighting requirements.¹¹⁰

The proposal provides for alternative treatment of securitization exposures to certain gains-on-sale and CEIO exposures. Specifically, the proposed

¹¹⁰ Requirements under either approach would likely be lower than the 1,250-percent risk weight.

rule would include a minimum 100-percent risk weight for interest-only MBS and exceptions to the securitization framework for certain small business loans and certain derivatives as described below. A System institution could use the securitization credit risk mitigation rules to adjust the capital requirement under the securitization framework for an exposure to reflect certain collateral, credit derivatives, and guarantees, as described in more detail below.

a. Exposure Amount of a Securitization Exposure

Under this proposal, the exposure amount of an on-balance sheet securitization exposure that is not a repo-style transaction, eligible margin loan, OTC derivative contract or derivative that is a cleared transaction would generally be the System institution’s carrying value of the exposure. The exposure amount of an on-balance sheet securitization exposure that is an available-for-sale debt security or an available-for-sale debt security transferred to held-to-maturity would be the System institution’s carrying value (including net accrued but unpaid interest and fees), less any net unrealized gains on the exposure and plus any net unrealized losses on the exposure.

The exposure amount of an off-balance sheet securitization exposure that is not a repo-style transaction, an eligible margin loan, an OTC derivative contract (other than a credit derivative), or a derivative that is a cleared transaction (other than a credit derivative) would be the notional amount of the exposure. The proposed treatment for OTC credit derivatives is described in more detail below.¹¹¹

Under the proposed rule, the exposure amount of a securitization exposure that is a repo-style transaction, eligible margin loan, an OTC derivative contract (other than a purchased credit derivative), or derivative that is a cleared transaction (other than a purchased credit derivative) would be the exposure amount of the transaction as calculated in § 628.34 or § 628.37, as applicable.

b. Gains-On-Sale and Credit-Enhancing Interest-Only Strips

Under this proposed rule, a System institution would deduct from CET1 capital any after-tax gain-on-sale

¹¹¹ The rules of the Federal banking regulatory agencies address how to calculate the exposure amount of an off-balance sheet exposure to an ABCP securitization exposure. As discussed above, we do not propose any provisions relating to ABCPs.

resulting from a securitization and would apply a 1,250-percent risk weight to the portion of a CEIO that does not constitute an after-tax gain-on-sale.

c. Exceptions Under the Securitization Framework

We propose several exceptions to the general provisions in the securitization framework. First, a System institution would be required to assign a risk weight of at least 100 percent to an interest-only MBS. The FCA believes that a minimum risk weight of 100 percent is prudent in light of the uncertainty implied by the substantial price volatility of these securities. Second, as in the capital regulations of the Federal banking regulatory agencies, a special set of rules would apply to securitizations of small business loans and leases on personal property transferred with retained contractual exposure by System institutions. Finally, if a securitization exposure is an OTC derivative contract or derivative contract that is a cleared transaction (other than a credit derivative) that has a first priority claim on the cash flows from the underlying exposures (notwithstanding amounts due under interest rate or currency derivative contracts, fees due, or other similar payments), a System institution may choose to set the risk-weighted asset amount of the exposure equal to the amount of the exposure.

d. Overlapping Exposures

This proposed rule includes provisions to limit the double counting of risks in situations involving overlapping securitization exposures. If a System institution has multiple securitization exposures that provide duplicative coverage to the underlying exposures of a securitization the institution would not be required to hold duplicative risk-based capital against the overlapping position. Instead, the System institution would apply to the overlapping position the applicable risk-based capital treatment under the securitization framework that results in the highest risk-based capital requirement.

e. Servicer Cash Advances

A traditional securitization typically employs a servicing banking organization (which could be a System institution) that, on a day-to-day basis, collects principal, interest, and other payments from the underlying exposures of the securitization and forwards such payments to the securitization SPE or to investors in the securitization. Servicing banking organizations often provide a facility to

the securitization under which the servicing banking organization may advance cash to ensure an uninterrupted flow of payments to investors in the securitization, including advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the underlying exposures. These servicer cash advance facilities are securitization exposures.

Under the proposed rule, a System institution would either apply the SSFA or the gross-up approach, as described below, or a 1,250-percent risk weight to a servicer cash advance facility exposure. The treatment of the undrawn portion of the facility would depend on whether the facility is an eligible servicer cash advance facility. An eligible servicer cash advance facility would be defined as a servicer cash advance facility in which:

(1) The servicer is entitled to full reimbursement of advances, except that a servicer may be obligated to make non-reimbursable advances for a particular underlying exposure if any such advance is contractually limited to an insignificant amount of the outstanding principal balance of that exposure;

(2) The servicer's right to reimbursement is senior in right of payment to all other claims on the cash flows from the underlying exposures of the securitization; and

(3) The servicer has no legal obligation to, and does not make, advances to the securitization if the servicer concludes the advances are unlikely to be repaid.

Under the proposal, a System institution that is a servicer under an eligible servicer cash advance facility would not be required to hold risk-based capital against potential future cash advanced payments that it may be required to provide under the contract governing the facility. A System institution that is a servicer under a non-eligible servicer cash advance facility would be required to hold risk-based capital against the amount of all potential future cash advance payments that it may be contractually required to provide during the subsequent 12-month period under the contract governing the facility.

f. Implicit Support

This proposed rule would require a System institution that provides support to a securitization in excess of its predetermined contractual obligation (implicit support) to include in risk-weighted assets all of the underlying exposures associated with the securitization as if the exposures had not been securitized, and deduct from

CET1 any after-tax gain-on-sale resulting from the securitization. In addition, the System institution would have to disclose publicly (i) that it has provided implicit support to the securitization, and (ii) the risk-based capital impact to the institution of providing such implicit support. Under the proposed reservations of authority, the FCA also could require the System institution to hold risk-based capital against all the underlying exposures associated with some or all the institution's other securitizations as if the exposures had not been securitized, and to deduct from CET1 any after-tax gain-on-sale resulting from such securitizations.

4. Simplified Supervisory Formula Approach

This rule proposes a SSFA as one option for assigning risk weights to securitization exposures.¹¹² The proposed SSFA starts with a baseline derived from the capital requirements that apply to all exposures underlying a securitization and then assigns risk weights based on the subordination level of an exposure. The proposed SSFA would apply relatively higher capital requirements to the more risky junior tranches of a securitization that are the first to absorb losses, and relatively lower requirements to the most senior exposures.

The SSFA methodology would apply a 1,250-percent risk weight to securitization exposures that absorb losses up to the amount of capital that would be required for the underlying exposures if those exposures were held directly by a System institution. In addition, the FCA is proposing a supervisory risk-weight floor, or minimum risk weight, of 20 percent for each securitization exposure. This floor is prudent given the performance of many securitization structures during the recent crisis.

At the inception of a securitization, the SSFA would require more capital on a transaction-wide basis than would be required if the underlying assets had not been securitized. That is, if the System institution held every tranche of a securitization, its overall capital charge would be greater than if the institution held the underlying assets in portfolio. This overall outcome is important in reducing the likelihood of regulatory capital arbitrage through securitizations.

Data used by a System institution to determine SSFA parameters would have to be the most currently available data. For exposures that feature payments on

¹¹² As discussed above, we propose a gross-up approach as another option for assigning risk weights to securitization exposures.

a monthly or quarterly basis, the data would have to be no more than 91 calendar days old.

To use the SSFA, a System institution would have to obtain or determine the weighted-average risk weight of the underlying exposures (K_G), as well as the attachment and detachment points for the System institution's position within the securitization structure. " K_G " would be calculated using the risk-weighted asset amounts and would be expressed as a decimal value between 0 and 1 (that is, an average risk weight of 100 percent would mean that K_G would equal 0.08). The System institution could recognize the relative seniority of the exposure, as well as all cash funded enhancements, in determining attachment and detachment points. In addition, a System institution would have to determine the credit performance of the underlying exposures.

To make the SSFA more risk sensitive and forward-looking, the parameter K_G would be modified based on delinquencies among the underlying assets of the securitization. The resulting adjusted parameter is labeled K_A . K_A is set equal to the weighted average of the K_G value and a fixed parameter equal to 0.5.

Under the proposal, the W parameter would equal the ratio of the sum of the dollar amounts of any underlying exposures of the securitization that are 90 days or more past due, subject to a bankruptcy or insolvency proceeding, in the process of foreclosure, held as real estate owned, in default, or have contractually deferred interest for 90 days or more divided by the ending balance, measured in dollars, of the underlying exposures.

The numerator of parameter W explicitly excludes loans with deferral of principal or interest for: (1) Federally

guaranteed student loans, in accordance with the terms of those programs; or (2) consumer loans, including non-federally guaranteed student loans, provided that such payments are deferred pursuant to provisions included in the contract at the time funds are disbursed that provide for period(s) of deferral that are not initiated based on changes in the creditworthiness of the borrower. Moreover, the calculation of parameter W includes all underlying exposures of a securitization transaction.

The entire specification of the SSFA in the proposed rule is as follows:

$$K_{SSFA} = \frac{e^{au} - e^{al}}{a(u-1)}$$

K_{SSFA} is the risk-based capital requirement for the securitization exposure and is a function of three variables, labeled a , u , and l . The constant e is the base of the natural logarithms (which is approximately equal to 2.71828). The variables a , u , and l , and have the following definitions:

$$a = -\frac{1}{p \times K_A}$$

$$u = D - K_A$$

$$l = \max(A - K_A, 0)$$

The values of A and D denote the attachment and detachment points, respectively, for the tranche.

Specifically, A is the attachment point for the tranche that contains the securitization exposure and represents the threshold at which credit losses will first be allocated to the exposure. This input is the ratio, as expressed as a decimal value between 0 and 1, of the dollar amount of the securitization exposures that are subordinated to the tranche that contains the securitization exposure held by the System institution to the current dollar amount of all underlying exposures.

Parameter D is the detachment point for the tranche that contains the securitization exposure and represents the threshold at which credit losses of principal allocated to the securitization exposure would result in a total loss of principal. This input, which is a decimal value between 0 and 1, equals the value of A plus the ratio of the dollar amount of the exposures that are *pari passu* with the System institution's securitization exposure (that is, have equal seniority with respect to credit risk) to the current dollar amount of all underlying exposures. The SSFA specification is completed by the constant term p , which is set equal to 0.5 for securitization exposures that are not resecuritizations, or 1.5 for resecuritization exposures, and the variable K_A , which is described above.

When parameter D for a securitization exposure is less than or equal to K_A , the exposure must be assigned a risk weight of 1,250 percent. When parameter A for a securitization exposure is greater than or equal to K_A , the risk weight of the exposure, expressed as a percent, would equal K_{SSFA} times 1,250. When parameter A is less than K_A and D is greater than K_A , the applicable risk weight is a weighted average of 1,250 percent and 1,250 percent times K_{SSFA} . The risk weight would be determined according to the following formula:

$$RW = \left[\left(\frac{K_A - A}{D - A} \right) \times 1,250 \text{ percent} \right] + \left[\left(\frac{D - K_A}{D - A} \right) \times 1,250 \text{ percent} \times K_{SSFA} \right]$$

For resecuritizations, System institutions must use the SSFA to measure the underlying securitization exposure's contribution to K_G . For example, consider a hypothetical securitization tranche that has an attachment point at 0.06 and a detachment point at 0.07. Then assume that 90 percent of the underlying pool of assets of the resecuritization were mortgage loans that qualified for a 50-percent risk weight and that the remaining 10 percent of the pool was a

tranche of a separate securitization (where the underlying 7 exposures consisted of mortgages that also qualified for a 50-percent weight). An exposure to this hypothetical tranche would meet the definition of a resecuritization exposure. Next, assume that the attachment point A of the securitization that is the 10-percent share of the resecuritization is 0.06 and the detachment point D is 0.08. Finally, assume that none of the underlying mortgage exposures of either the

hypothetical tranche or the underlying securitization exposure meet the proposed definition of "delinquent."

The value of K_G for the resecuritization exposure would equal the weighted average of the two distinct K_G values. For the mortgages that qualify for the 50-percent risk weight and represent 90 percent of the resecuritization, K_G equals 0.04 (that is, 50 percent of the 8-percent risk-based capital standard).

$$K_{G, \text{resecuritization}} = (0.9 - 0.04) + (0.1 \times K_{G, \text{securitization}})$$

To calculate the value of $K_{G, \text{securitization}}$ a System institution would use the attachment and detachment points of 0.06 and 0.08, respectively. Applying

those input parameters to the SSFA (together with $p = 0.5$ and $K_G = 0.04$) results in a $K_{G, \text{securitization}}$ equal to 0.2325.

Substituting this value into the equation yields:

$$K_{G, \text{resecuritization}} = (0.9 + 0.04) + (0.1 + 0.2325) = 0.05925$$

This value of 0.05925 for $K_{G, \text{resecuritization}}$, would then be used in the calculation of the risk-based capital requirement for the tranche of the resecuritization (where $A = 0.06$, $B = 0.07$, $p = 1.5$). The result is a risk-weight of 1,172 percent for the tranche that runs from 0.06 to 0.07. Given that the attachment point is very close to the value of $K_{G, \text{resecuritization}}$, the capital charge is nearly equal to the maximum risk weight of 1,250 percent.

To apply the securitization framework to a single tranching exposure that has been re-tranched, such as some Re-REMICs, a System institution must apply the SSFA or gross-up approach to the retransched exposure as if it were still part of the structure of the original securitization transaction. Therefore, a System institution implementing the SSFA or the gross-up approach would calculate parameters for those approaches that would treat the retransched exposure as if it were still embedded in the original structure of the transaction while still recognizing any added credit enhancement provided by retransching. For example, under the SSFA a System institution would calculate the approach using hypothetical attachment and detachment points that reflect the seniority of the retransched exposure within the original deal structure, as well as any additional credit enhancement provided by retransching of the exposure. Parameters that depend on pool-level characteristics, such as the W parameter under the SSFA, would be calculated based on the characteristics of the total underlying exposures of the initial securitization transaction, not just the retransched exposure.

5. Gross-up Approach

As an alternative to the SSFA, System institutions may assign risk-weighted asset amounts to securitization exposures by implementing the gross-up approach described in § 628.43 of the proposal. If a System institution chooses to apply the gross-up approach, it would be required to apply this approach to all of its securitization exposures, except as otherwise provided for certain

securitization exposures under §§ 628.44 and 628.45 of the proposal.

The gross-up approach assigns risk-weighted asset amounts based on the full amount of the credit-enhanced assets for which the System institution directly or indirectly assumes credit risk. To calculate risk-weighted assets under the gross-up approach, a System institution would determine four inputs: the pro rata share A , the exposure amount C , the enhanced amount B , and the applicable risk weight RW . The pro rata share A is the par value of the System institution's exposure X as a percentage of the par value of the tranche Y in which the securitization exposure resides $A = \frac{X}{Y}$. The enhanced amount B is the value of all the tranches that are more senior to the tranche in which the exposure resides. The applicable risk weight RW is the weighted-average risk weight of the underlying exposures in the securitization (for example, 100 percent for a corporate exposure).

Under the gross-up approach, a System institution would be required to calculate the credit equivalent amount CEA , which equals the sum of (1) the exposure of the System institution's securitization exposure and (2) the pro rata share multiplied by the enhanced amount $CEA = C + (A \times B)$. To calculate risk-weighted assets RWA for a securitization exposure under the gross-up approach, a System institution would be required to assign the applicable risk weight to the gross-up credit equivalent amount $RWA = RW \times CEA$. As noted above, in all cases, the minimum risk weight for securitization exposures would be 20 percent.

6. Alternative Treatments for Certain Types of Securitization Exposures

Under the proposed rule, a System institution generally would assign a 1,250-percent risk weight to all securitization exposures to which the institution does not apply the SSFA or the gross-up approach. However, the proposed rule provides alternative treatments for certain types of securitization exposures described below, provided that the System

institution knows the composition of the underlying exposures at all times.

7. Credit Risk Mitigation for Securitization Exposures

Under the proposed rule, the treatment of credit risk mitigation for securitization exposures would differ slightly from the treatment for other exposures. To recognize the risk-mitigating effects of financial collateral or an eligible guarantee or an eligible credit derivative from an eligible guarantor, a System institution that purchased credit protection would use the approaches for collateralized transactions under § 628.37 of the proposed rule or the substitution treatment for guarantees and credit derivatives described in § 628.36 of the proposed rule.

In cases of maturity or currency mismatches, or, if applicable, lack of a restructuring event trigger, the institution would have to make any applicable adjustments to the protection amount of an eligible guarantee or credit derivative as required by § 628.36 for any hedged securitization exposure. In addition, for synthetic securitizations, when an eligible guarantee or eligible credit derivative covers multiple hedged exposures that have different residual maturities, the System institution would have to use the longest residual maturity of any of the hedged exposures as the residual maturity of all the hedged exposures. A System institution would not be required to compute a counterparty credit risk capital requirement for the credit derivative provided that this treatment is applied consistently for all of its OTC credit derivatives.

A System institution that purchases an OTC credit derivative (other than an nth-to-default credit derivative) that is recognized as a credit risk mitigant for a securitization exposure would not be required to compute a separate counterparty credit risk capital requirement provided that the institution makes this choice consistently for all such credit derivatives. The System institution would have to either include all or

exclude all such credit derivatives that are subject to a qualifying master netting agreement from any measure used to determine counterparty credit risk exposure to all relevant counterparties for risk-based capital purposes.

If a System institution could not, or chose not to, recognize a credit derivative that is a securitization exposure as a credit risk mitigant, the institution would have to determine the exposure amount of the credit derivative under the treatment for OTC derivatives in § 628.34. If the System institution purchased the credit protection from a counterparty that is a securitization, the institution would have to determine the risk weight for counterparty credit risk according to the securitization framework. If the System institution purchased credit protection from a counterparty that is not a securitization, the institution would have to determine the risk weight for counterparty credit risk according to general risk weights under § 628.32. A System institution that believes it is authorized to and wishes to provide protection in the form of a guarantee or credit derivative (other than an nth-to-default credit derivative) that covers the full amount or a pro rata share of a securitization exposure's principal and interest should seek guidance from the FCA on risk weighting and other issues. We do not propose the capital treatment adopted by the Federal banking regulatory agencies, because we would want the opportunity to fully consider any contemplated transaction before assigning a risk weighting.

8. Nth-to-Default Credit Derivatives

A System institution that believes it is authorized to and wishes to provide credit protection through an nth-to-default credit derivative or second-or-subsequent-to default credit derivative should seek guidance from the FCA on risk weighting and other issues. As with the capital treatment for providing credit protection discussed above, we do not propose the capital treatment adopted by the Federal banking regulatory agencies for these derivatives, because we would want the opportunity to fully consider any contemplated transaction before assigning a risk weighting.

A System institution could obtain credit protection on a group of underlying exposures through a first-to-default credit derivative. Provided the rules of recognition for guarantees and credit derivatives under § 628.36(b) were met, the System institution would determine its risk-based capital requirement for the underlying exposures as if the institution

synthetically securitized the underlying exposure with the smallest risk-weighted asset amount and had obtained no credit risk mitigant on the other underlying exposures. A System institution would calculate a risk-based capital requirement for counterparty credit risk according to § 628.34 for a first-to-default credit derivative that does not meet the rules of recognition of § 628.36(b).

A System institution could obtain credit protection on a group of underlying exposures through a nth-to-default credit derivative. Provided the rules of recognition of § 628.36(b) (other than a first-to-default credit derivative) were met, the System institution could recognize the credit risk mitigation benefits of the derivative only if the institution also had obtained credit protection on the same underlying exposures in the form of first-through-(n-1)-to-default credit derivatives; or if n-1 of the underlying exposures had already defaulted. If a System institution satisfied these requirements, the institution would determine its risk-based capital requirement for the underlying exposures as if the institution had only synthetically securitized the underlying exposure with the nth smallest risk-weighted asset amount and had obtained no credit risk mitigant on the other underlying exposures. For a nth-to-default credit derivative that did not meet the rules of recognition of § 628.36(b), a System institution would calculate a risk-based capital requirement for counterparty credit risk according to the treatment of OTC derivatives under § 628.34.

I. Equity Exposures

As discussed above, all equities (including preferred stock) issued by other System institutions would be deducted from capital under § 628.22. Accordingly, we do not propose a risk weighting for these equity exposures. These intra-System equity exposures would include an association's investment in its System bank, a System bank's purchase of nonvoting stock or participation certificates of an affiliated association pursuant to § 615.5171, and the purchase of a System institution's preferred stock by a System bank, association, or service corporation pursuant to § 615.5175.

Generally, System institutions have limited non-System equity exposures. A System institution could, however, acquire limited non-System equity exposures in several ways, including by investing in rural business investment companies (RBICs), by making other equity investments that the FCA

approves,¹¹³ and by foreclosing on equity exposures previously pledged as collateral.

This proposal would significantly revise our existing risk-based capital rules' treatment for non-System equity exposures. In particular, the proposed rule would require a System institution to apply the Simple Risk-Weight Approach (SRWA) for equity exposures that are not exposures to an investment fund and apply certain look-through approaches to assign risk-weighted asset amounts to equity exposures to an investment fund. These approaches are discussed in detail below.

1. Definition of Equity Exposure and Exposure Measurement

Under the proposed rule, a System institution would be required to determine the adjusted carrying value for each non-System equity exposure based on the approaches described below:

(1) For an equity exposure classified as HTM¹¹⁴ the adjusted carrying value would be a System institution's carrying value of the exposure;

(2) For an equity exposure classified as AFS, the adjusted carrying value of the exposure would be the System institution's carrying value of the exposure less any net unrealized gains on the exposure that are reflected in the carrying value but excluded from the System institution's regulatory capital components;

(3) For a commitment to acquire an equity exposure that is unconditional, the adjusted carrying value would be the effective notional principal amount of the exposure multiplied by a 100-percent conversion factor;

(4) For a commitment to acquire an equity exposure that is conditional, the adjusted carrying value would be the effective notional principal amount of the commitment multiplied by a conversion factor. For a commitment with an original maturity of 14 months or less, the conversion factor would be 20 percent, and for a commitment with an original maturity greater than 14 months, the conversion factor would be 50 percent; and

¹¹³ System institutions have no authority to make non-System equity investments, other than in RBICs, unless they receive the FCA's approval under § 615.5140(e). Authority for System institutions to invest in RBICs is governed by 7 U.S.C. 2009cc *et seq.*; these investments do not require the FCA's approval. However, as with any UBE investment, the FCA's approval is required for a System institution to invest in a UBE organized for investing in an RBIC.

¹¹⁴ As noted above, although System banks often classify their securities as AFS, associations usually classify their securities; to the extent, they hold any, as HTM.

(5) For the off-balance sheet component of an equity exposure that is not an equity commitment, the adjusted carrying value would be the effective notional principal amount of the exposure. The size of the exposure would be equivalent to a hypothetical on-balance sheet position in the underlying equity instrument that would evidence the same change in fair value (measured in dollars) for a given small change in the price of the underlying equity instrument, minus the adjusted carrying value of the on-balance sheet component of the exposure.

The concept of the effective notional principal amount of the off-balance sheet portion of an equity exposure is included to provide a uniform method for System institutions to measure the on-balance sheet equivalent of an off-balance sheet exposure. For example, if

the value of a derivative contract referencing the common stock of company X changes the same amount as the value of 150 shares of common stock of company X, for a small change (for example, 1.0 percent) in the value of the common stock of company X, the effective notional principal amount of the derivative contract is the current value of 150 shares of common stock of company X, regardless of the number of shares the derivative contract references. The adjusted carrying value of the off-balance sheet component of the derivative is the current value of 150 shares of common stock of company X minus the adjusted carrying value of any on-balance sheet amount associated with the derivative.

2. Equity Exposure Risk Weights

Under the proposed SRWA for equity exposures, a System institution would

determine the risk-weighted asset amount for an equity exposure, other than an equity exposure to an investment fund, under § 628.52 of the proposed rule. A System institution would calculate risk-weighted asset amounts under § 628.52 by multiplying the adjusted carrying value of the equity exposure, or the effective and ineffective portions of a hedge pair as described below, by the lowest applicable risk weight in § 628.52. A System institution would determine the risk-weighted asset amount for an equity exposure to an investment fund under § 628.53 of the proposal. A System institution would sum risk-weighted asset amounts for all of its equity exposures to calculate its aggregate risk-weighted asset amount for its equity exposures.

The proposed SRWA risk weights are summarized below in Table 10.

TABLE 10—SIMPLE RISK-WEIGHT APPROACH (SRWA)

Risk Weight (in percent)	Equity exposure
0	An equity exposure to a sovereign, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, an MDB, and any other entity whose credit exposures receive a 0-percent risk weight under § 628.32 of the proposal.
20	An equity exposure to a PSE or the Federal Agricultural Mortgage Corporation (Farmer Mac).
100	<ul style="list-style-type: none"> An equity exposure that the FCA has authorized pursuant to § 615.5140(e) for a purpose other than those specified in § 615.5132(a) (for System banks) or § 615.5142 (for associations), unless the exposure is assigned a different risk weight under this section. The effective portion of a hedged pair. Non-significant equity exposures, to the extent that the aggregate adjusted carrying value of the exposures does not exceed 10 percent of total capital (tier 1 capital plus tier 2 capital).
600	An equity exposure to an investment firm that (i) would meet the definition of a traditional securitization were it not for the FCA's application of paragraph (8) of that definition (in § 628.2) and (ii) has greater than immaterial leverage.

3. 100-Percent Risk Weight

Under this proposed rule, a System institution would apply a 100-percent risk weight to the following equity exposures:

- An equity exposure that the FCA has authorized pursuant to § 615.5140(e) for a purpose other than those specified in § 615.5132(a) (for System banks) or § 615.5142 (for associations), unless the equity exposure is assigned a different risk weight under this section.

- The effective portion of a hedge pair; and
- Non-significant equity exposures.

Hedged transactions are discussed later in this preamble; the other two equity exposures are discussed in this section.

Section § 615.5132(a) of the FCA's regulations authorizes System banks to invest in eligible securities (equity securities are not eligible) for the purposes of complying with liquidity requirements, managing surplus short-term funds, and managing interest rate risk. Section § 615.5142 authorizes

associations to invest in eligible securities (again, equity securities are not eligible) for the purposes of reducing interest rate risk and managing surplus short-term funds. Section 615.5140(e) authorizes System banks and associations, with our approval, to purchase and hold investments that are not otherwise eligible (such as equity investments) or that would be held for a purpose not specified by regulation.

Under proposed § 628.52, equity investments that the FCA approves for a purpose other than those specified in § 615.5132(a) (for System banks) or § 615.5142 (for associations) would be risk weighted at 100 percent, unless the investments would qualify for a different risk weight (for example, 0 percent or 20 percent) under this section.

Under the proposed rule, a 100-percent risk weight would also apply to certain non-System equity exposures deemed non-significant. The following equity exposures, to the extent that their aggregate adjusted carrying value of

does not exceed 10 percent of the System institution's total capital (tier 1 and tier 2), would be deemed non-significant:¹¹⁵

- Equity exposures to unconsolidated unincorporated business entities and equity exposures held through consolidated unincorporated business entities, as authorized by subpart J of part 611;
- Equity exposures that the FCA has authorized pursuant to § 615.5140(e) for a purpose specified in § 615.5132(a) (for System banks) or § 615.5142 (for associations), unless the equity exposures are assigned a different risk weight under this section; and
- Equity exposures to an unconsolidated rural business investment company and equity

¹¹⁵ Non-significant equity exposures exclude exposures to an investment firm that (1) would meet the definition of traditional securitization were it not for the FCA's application of paragraph (8) of the definition of a traditional securitization and (2) have greater than immaterial leverage. These investment firm exposures would be assigned a 600-percent risk weight.

exposures held through a consolidated rural business investment company described in 7 U.S.C. 2009cc *et seq.*

- Equity exposures to foreclosed collateral; these exposures could be either publicly traded or non-publicly traded.¹¹⁶

To compute the aggregate adjusted carrying value of a System institution's equity exposures for determining their non-significance, this proposal provides that the System institution may exclude: (1) The equity exposure in a hedge pair with the smaller adjusted carrying value; and (2) a proportion of each equity exposure to an investment fund equal to the proportion of the assets of the investment fund that are not equity exposures. If a System institution does not know the actual holdings of the investment fund, the System institution may calculate the proportion of the assets of the fund that are not equity exposures based on the terms of the prospectus, partnership agreement, or similar contract that defines the fund's permissible investments. If the sum of the investment limits for all exposure classes within the fund exceeds 100 percent, the System institution would assume that the investment fund invests to the maximum extent possible in equity exposures.

To determine which of a System institution's equity exposures qualify for a 100-percent risk weight based on the 10 percent of capital standard for non-significance, the System institution would aggregate the exposures in the following order:

(1) Equity exposures to unconsolidated rural business investment companies, or those held through consolidated rural business investment companies described in 7 U.S.C. 2009cc *et seq.*;

(2) Equity exposures that the FCA has authorized pursuant to § 615.5140(e) for a purpose specified in § 615.5132(a) (for System banks) or § 615.5142 (for associations);

(3) Equity exposures to unconsolidated unincorporated business entities and equity exposures held through consolidated unincorporated business entities, as authorized by subpart J of part 611;

(4) Foreclosed collateral in the form of publicly traded equity exposures (including those held indirectly through investment funds); and

(5) Foreclosed collateral in the form of non-publicly traded equity exposures (including those held indirectly through investment funds).

To the extent that any of these aggregated equity exposures exceed 10 percent of a System institution's total capital, the FCA will determine their risk weighting.

4. Hedged Transactions

Under the proposal, to determine risk-weighted assets under the SRWA, a System institution could identify hedge pairs, which would be defined as two equity exposures that form an effective hedge, as long as each equity exposure is publicly traded or has a return that is primarily based on a publicly traded equity exposure. A System institution would risk weight only the effective and ineffective portions of a hedge pair rather than the entire adjusted carrying value of each exposure that makes up the pair.

Under the proposed rule, two equity exposures form an effective hedge if the exposures either have the same remaining maturity or each has a remaining maturity of at least 3 months; the hedge relationship is formally documented in a prospective manner (that is, before the System institution acquires at least one of the equity exposures); the documentation specifies the measure of effectiveness (E) the System institution would use for the hedge relationship throughout the life of the transaction; and the hedge relationship has an E greater than or equal to 0.8. A System institution would measure E at least quarterly and would use one of three measures of E described in the next section: The dollar-offset method, the variability-reduction method, or the regression method.

It is possible that only part of a System institution's exposure to a particular equity instrument is part of a hedge pair. For example, assume a System institution has equity exposure A with a \$300 adjusted carrying value and chooses to hedge a portion of that exposure with equity exposure B with an adjusted carrying value of \$100. Also assume that the combination of equity exposure B and \$100 of the adjusted carrying value of equity exposure A form an effective hedge with an E of 0.8. In this situation, the institution would treat \$100 of equity exposure A and

\$100 of equity exposure B as a hedge pair, and the remaining \$200 of its equity exposure A as a separate, stand-alone equity position. The effective portion of a hedge pair would be calculated as E multiplied by the greater of the adjusted carrying values of the equity exposures forming the hedge pair. The ineffective portion of a hedge pair would be calculated as (1-E) multiplied by the greater of the adjusted carrying values of the equity exposures forming the hedge pair. In the above example, the effective portion of the hedge pair would be $0.8 \times \$100 = \80 , and the ineffective portion of the hedge pair would be $(1 - 0.8) \times \$100 = \20 .

5. Measures of Hedge Effectiveness

As stated above, a System institution could determine effectiveness using any one of three methods—the dollar-offset method, the variability-reduction method, or the regression method. Under the dollar-offset method, a System institution would determine the ratio of the cumulative sum of the changes in value of one equity exposure to the cumulative sum of the changes in value of the other equity exposure, termed the ratio of value change (RVC). If the changes in the values of the two exposures perfectly offset each other, the RVC would be -1 . If RVC is positive, implying that the values of the two equity exposures move in the same direction, the hedge is not effective and E equals 0. If RVC is negative and greater than or equal to -1 (that is, between 0 and -1), then E would equal the absolute value of RVC. If RVC is negative and less than -1 , then E would equal 2 plus RVC.

The variability-reduction method of measuring effectiveness compares changes in the value of the combined position of the two equity exposures in the hedge pair (labeled X in the equation below) to changes in the value of one exposure as though that one exposure were not hedged (labeled A). This measure of E expresses the time-series variability in X as a proportion of the variability of A. As the variability described by the numerator becomes small relative to the variability described by the denominator, the measure of effectiveness improves, but is bounded from above by a value of one. E would be computed as:

¹¹⁶ This proposal defines publicly traded as traded on: (1) Any exchange registered with the SEC as a national securities exchange under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f); or (2) any non-U.S.-based securities exchange that

is registered with, or approved by, a national securities regulatory authority and that provides a liquid, two-way market for the instrument in question. A two-way market would refer to a market where there are independent bona fide offers to buy

and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined within 1 day and settled at that price within a relatively short timeframe conforming to trade custom.

$$E = 1 - \frac{\sum_{t=1}^T (X_t - X_{t-1})^2}{\sum_{t=1}^T (A_t - A_{t-1})^2}$$

where

$$X_t = A_t - B_t$$

A_t , the value at time t of the one exposure in a hedge pair, and

B_t , the value at time t of the other exposure in the hedge pair.

The value of t would range from 0 to T , where T is the length of the observation period for the values of A and B , and is comprised of shorter values each labeled t .

The regression method of measuring effectiveness is based on a regression in which the change in value of one exposure in a hedge pair is the dependent variable and the change in value of the other exposure in the hedge pair is the independent variable. E would equal the coefficient of determination of this regression, which is the proportion of the variation in the dependent variable explained by variation in the independent variable. However, if the estimated regression coefficient is positive, then the value of E is 0. Accordingly, E is higher when the relationship between the values of the two exposures is closer.

6. Equity Exposures to Investment Funds

We propose three methods of assigning risk weights to equity exposures to investment funds. Regardless of the method a System institution chooses, the risk weight for an exposure to an investment fund would have to be no less than 20 percent.¹¹⁷ System institutions should keep in mind that the only investment funds they are authorized to invest in are diversified investment funds; that is, shares of an investment company registered under section 8 of the Investment Company Act of 1940. The portfolio of the investment company must consist solely of eligible investments authorized by our investment regulations.¹¹⁸

As discussed further below, under the proposed rule, a System institution would determine the risk-weighted asset amount for equity exposures (except equity exposures that the FCA has authorized pursuant to § 615.5140(e) for a purpose other than those specified in § 615.5132(a) (for System banks) or § 615.5142 (for associations)) to investment funds using one of three

approaches—the full look-through approach, the simple modified look-through approach, or the alternative modified look-through approach. The risk-weighted asset amount for an equity exposure that the FCA has authorized pursuant to § 615.5140(e) for a purpose other than those specified in § 615.5132(a) (for System banks) or § 615.5142 (for associations) is the exposure's adjusted carrying value. If a System institution did not use the full look-through approach, and an equity exposure to an investment fund was part of a hedge pair, the System institution would have to use the ineffective portion of the hedge pair as the adjusted carrying value for the equity exposure to the investment fund. The risk-weighted asset amount of the effective portion of the hedge pair would be equal to its adjusted carrying value. A System institution could choose which approach to apply for each equity exposure to an investment fund.

a. Full Look-Through Approach

A System institution could use the full look-through approach only if the institution was able to calculate a risk-weighted asset amount for each of the exposures held by the investment fund. Under the proposal, a System institution using the full look-through approach would be required to calculate the risk-weighted asset amount for its proportional ownership shares of each of the exposures held by the investment fund as if the proportionate ownership share of the adjusted carrying value of each of the exposures were held directly by the institution. The System institution's risk-weighted asset amount for the fund would be equal to (1) The aggregate risk-weighted asset amount of the exposures held by the fund as if they were held directly by the System institution multiplied by (2) the System institution's proportional ownership share of the fund.

b. Simple Modified Look-Through Approach

Under the proposed simple modified look-through approach, a System institution would set the risk-weighted asset amount for its equity exposure to an investment fund equal to the adjusted carrying value of the equity exposure multiplied by the highest risk weight that applies to an exposure the fund is permitted to hold under the prospectus, partnership agreement, or similar agreement that defines the

fund's permissible investments. The System institution may exclude derivative contracts held by the fund that are used for hedging, rather than for speculative purposes, as long as they do not constitute a material portion of the fund's exposures.

c. Alternative Modified Look-Through Approach

Under the proposed alternative modified look-through approach, a System institution may assign the adjusted carrying value of an equity exposure to an investment fund on a pro rata basis to different risk-weight categories based on the investment limits in the fund's prospectus, partnership agreement, or similar contract that defines the fund's permissible investments.

The risk-weighted asset amount for the System institution's equity exposure to the investment fund would be equal to the sum of each portion of the adjusted carrying value assigned to an exposure type multiplied by the applicable risk weight. If the sum of the investment limits for all exposures within the fund exceeds 100 percent, the System institution would assume that the fund invests to the maximum extent permitted under its investment limits in the exposure type with the highest applicable risk weight under the proposed requirements and continues to make investments in the order of the exposure category with the next highest risk weight until the maximum total investment level is reached. If more than one exposure category applies to an exposure, the System institution would use the highest applicable risk weight. A System institution may exclude derivative contracts held by the fund that are used for hedging, rather than for speculative purposes, as long as they do not constitute a material portion of the fund's exposures.

V. Market Discipline and Disclosure Requirements

A. Proposed Disclosure Requirements

Meaningful public disclosure by banking organizations is one of the three pillars of the Basel framework. Public disclosure complements the minimum capital requirements and the supervisory review process by encouraging market discipline. The other Federal banking regulatory agencies adopted disclosure requirements for the banking

¹¹⁷ As with non-System equity exposures generally, System institutions generally have limited equity exposures to investment funds.

¹¹⁸ Section 615.5140(a)(8).

organizations that they regulate with \$50 billion or more in assets.

We propose similar disclosure requirements for System banks on a bank-only basis (not on a consolidated, district-wide basis). We believe these proposed disclosure requirements are appropriate for all System banks—even those that currently have less than \$50 billion in assets—because they are jointly and severally liable for the Systemwide debt obligations that they issue.¹¹⁹ A System bank's exposure to risks and the techniques that it uses to identify, measure, monitor, and control those risks are important factors that market participants consider in their assessment of the bank. A System bank would not, however, have to make any disclosures that do not apply to it.¹²⁰

We believe this proposal strikes the proper balance between the market benefits of disclosure and the burden of providing the disclosures. We invite comment on the appropriate application of these proposed disclosure requirements to System banks.

We propose to require each System bank to have a board-approved disclosure policy that addresses the bank's approach for determining the disclosures it will make. The policy would address the associated internal controls, disclosure controls, and procedures. The board of directors and senior management would ensure that disclosures are reviewed appropriately and that effective internal controls, disclosure controls, and procedures are maintained. The System bank's chief executive officer, chief financial officer, and a designated board member would have to attest that the disclosures meet the requirements of these regulations.

A System bank would decide the relevant material disclosures. Information would be regarded as material if its omission or misstatement could influence the assessment or decision of a user making investment decisions.

We would expect that disclosures of CET1, tier 1, and total capital ratios would be tested by external auditors as part of the financial statement audit in a manner similar to the testing that external auditors perform on banking organizations regulated by the Federal banking regulatory agencies.

¹¹⁹ Nothing in this proposed regulation or preamble would change any of our existing regulatory requirements, including those in part 620 or part 621.

¹²⁰ For example, Table 1 would require a System bank to make certain disclosures about subsidiaries. If a System bank has no subsidiaries, it would not have to make those disclosures.

B. Location and Frequency of Disclosures

This proposed rule would require that a System bank provide timely public disclosures after each calendar quarter. However, qualitative disclosures that provide a general summary of a System bank's risk-management objectives and policies, reporting system, and definitions may be disclosed annually after the end of the fourth calendar quarter, provided any significant changes are disclosed in the interim.

The System bank would have to make these disclosures in its quarterly and annual reports to shareholders that are required in part 620 of our regulations.¹²¹ We do not require a System bank to make these disclosures in the exact format set out in the proposed regulations, or in the same location in the report, as long as they provide a summary table specifically indicating the location(s) of all disclosures. This flexibility grants System banks discretion in how to disclose the required information and to avoid duplication.

In some cases, management may determine that a significant change has occurred, such that the most recent reported amounts do not reflect the System bank's capital adequacy and risk profile. In those cases, the System bank would need to disclose the general nature of these changes and briefly describe how they are likely to affect public disclosures going forward. A System bank would have to make these interim disclosures as soon as practicable after the determination that a significant change has occurred. This disclosure requirement may be satisfied by providing a notice under § 620.15.

The disclosures required by the proposal would have to be publicly available (for example, included on a public Web site) for each of the last 3 years or such shorter time period beginning when the System bank becomes subject to the disclosure requirements. For example, a System bank that began to make public disclosures in the first quarter of 2015 would have to make all of its required disclosures publicly available until the first quarter of 2018, after which it would have to make its required

¹²¹ Sections 620.2 and 620.4 of the FCA's regulations requires each System institution to prepare, provide to the FCA and shareholders, and make available to the public an annual report after the end of each fiscal year. Sections 620.2 and 620.10 requires each System institution to prepare, provide to the FCA and shareholders, and make available to the public a quarterly report after the end of each fiscal quarter (except the fiscal quarter that coincides with the end of the System institution's fiscal year).

disclosures for the previous 3 years publicly available.

C. Proprietary and Confidential Information

The FCA believes that proposed disclosure requirements strike the proper balance between the need for meaningful disclosure and the protection of proprietary and confidential information.¹²² Accordingly, the FCA believes System banks would be able to provide all of these disclosures without revealing proprietary and confidential information. Only in rare circumstances might disclosure of certain items of information required by the proposal compel a System bank to reveal confidential and proprietary information. In these unusual situations, if a System bank believes that disclosure of specific commercial or financial information would compromise its position by making public information that is either proprietary or confidential in nature, the System bank would not be required to disclose those specific items under the rule's periodic disclosure requirements. Instead, the System bank would have to disclose more general information about the subject matter of the requirement, together with the fact that, and the reason why, the specific items of information have not been disclosed. This provision would apply only to those disclosures included in this proposed rule and would not apply to disclosure requirements imposed by accounting standards or other FCA regulations.

D. Specific Public Disclosure Requirements

The public disclosure requirements are designed to provide important information to market participants on the scope of application, capital structure, risk exposures, risk assessment processes, and the capital adequacy of the System institution. The focus of the proposed disclosure requirements is the substantive content of the tables, not the tables themselves. The table numbers below refer to the table numbers in proposed § 628.63. A System bank would be required to make the disclosures described in Tables 1 through 10.¹²³

¹²² Proprietary information encompasses information that, if shared with competitors, would render a System bank's investment in these products/systems less valuable, and, hence, could undermine its competitive position. Information about customers is often confidential, in that it is provided under the terms of a legal agreement or counterparty relationship.

¹²³ Other disclosure requirements, such as regulatory reporting requirements, would continue to apply.

Table 1 disclosures, “Scope of Application,” would provide the basic context underlying regulatory capital calculations.

Table 2 disclosures, “Capital Structure,” would provide summary information on the terms and conditions of the main features of regulatory capital instruments, which would allow for an evaluation of the quality of the capital available to absorb losses within a System bank. A System bank also would disclose the total amount of CET1, tier 1, and total capital, with separate disclosures for deductions and adjustments to capital. We believe that many of these disclosure requirements would be captured in revised regulatory reports.

Table 3 disclosures, “Capital Adequacy,” would provide information on a System bank’s approach for categorizing and risk-weighting its exposures, as well as the amount of total risk-weighted assets. The table would also include CET1, and tier 1 and total risk-based capital ratios.

Table 4 disclosures, “Capital Conservation Buffer,” would require a System bank to disclose the capital conservation buffer, the eligible retained income and any limitations on capital distributions and certain discretionary bonus payments, as applicable.

Disclosures in Tables 5, “Credit Risk: General Disclosures,” 6, “General Disclosure for Counterparty Credit Risk-Related Expenses,” and 7, “Credit Risk Mitigation,” would relate to credit risk, counterparty credit risk and credit risk mitigation, respectively, and would provide market participants with insight into different types and concentrations of credit risk to which a System bank is exposed and the techniques it uses to measure, monitor, and mitigate those risks. These disclosures are intended to enable market participants to assess the credit risk exposures of the System bank without revealing proprietary information.

Table 8 disclosures, “Securitization,” would provide information to market participants on the amount of credit risk transferred and retained by a System bank through securitization transactions, the types of products involved in the System bank’s securitizations, the risks inherent in the System bank’s securitized assets, the System bank’s policies regarding credit risk mitigation, and the names of any entities that provide external credit assessments of a securitization. These disclosures would provide a better understanding of how securitization transactions impact the credit risk of a System bank. For purposes of these disclosures (and these capital

regulations), a System bank would be considered to have securitized assets if assets that it originated or purchased from third parties are included in a securitization. Securitization transactions in which the originating System bank does not retain any securitization exposure would be shown separately and would only be reported for the year of inception of the transaction.¹²⁴

Table 9 disclosures, “Equities,” would provide market participants with an understanding of the types of equity securities held by the System bank and how they are valued. The disclosures would also provide information on the capital allocated to different equity products and the amount of unrealized gains and losses. We understand that System banks generally hold few equity securities; nevertheless, we believe disclosure of these securities, when they are held, is warranted.

Table 10 disclosures, “Interest Rate Risk for Non-trading Activities,” would require a System bank to provide certain quantitative and qualitative disclosures regarding the System bank’s management of interest rate risks.

VI. Conforming Changes

The FCA is proposing a number of conforming changes to current FCA regulations as follows:

- In § 607.2(b), revision of the definition of “average risk-adjusted asset base”;
- In § 614.4351(a)(3), replacement of the reference to total surplus with a reference to tier 2 capital;
- In § 615.5143(a), removal of references to the net collateral ratio;
- In § 615.5200, removal of references to total capital, surplus, core surplus, total surplus, and unallocated surplus; addition of references to CET1, tier 1 capital, total capital, and tier 1 leverage ratio; and other minor nonsubstantive and technical changes;
- In § 615.5201, removal of definitions that would no longer be used in part 615, subpart H, including “bank,” “commitment,” “credit conversion factor,” “credit derivative,” “credit-enhancing interest-only strip,” “credit-enhancing representations and warranties,” “deferred-tax assets that are dependent on future income or future events,” “direct credit

¹²⁴ A System bank is authorized to act as an “originating System institution,” which the proposed regulation would define as a System institution that directly or indirectly originated the underlying exposures included in a securitization. A System bank is not authorized to perform every role in a securitization, and nothing in these capital rules authorizes a System bank to engage in activities relating to securitizations that are not otherwise authorized.

substitute,” “direct lender institution,” “externally rated,” “face amount,” “financial asset,” “financial standby letter of credit,” “Government agency,” “Government-sponsored agency,” “institution,” “nationally recognized statistical rating organization,” “non-OECD bank,” “OECD,” “OECD bank,” “performance-based standby letter of credit,” “qualified residential loan,” “qualifying bilateral netting contract,” “qualifying securities firm,” “recourse,” “residual interest,” “risk participation,” “Rural Business Investment Company,” “securitization,” “servicer cash advance,” “total capital,” “traded position,” and “U.S. depository institution”; revision of the definitions of “permanent capital” and “risk-adjusted asset base”; and addition of definitions of “deferred tax assets” and “System institution”;

- In §§ 615.5206 and 615.5208, removal of references to the Farm Credit System Financial Assistance Corporation in § 615.5206(a); removal of §§ 615.5206(d) and 615.5208(c), which pertain to the Farm Credit System Financial Assistance Corporation; and other minor nonsubstantive and technical changes;

- In § 615.5207, revisions in paragraph (f) (requiring deduction of an investment in the Funding Corporation) and paragraph (j) (elimination of exclusion of AOCI and requirement to exclude any defined benefit pension fund net asset) to make the deductions from the numerator of the permanent capital calculation uniform with the deductions from the denominator;

- Removal of §§ 615.5209 through 615.5212, which pertain to risk-weighting (the risk-weights for the permanent capital ratio would be the same risk weights that would be used for the tier 1 and tier 2 capital ratios in part 628);

- In § 615.5220, minor nonsubstantive and technical changes;

- Revision of § 615.5240 to add a reference to the regulatory capital standards in proposed part 628;

- Revision of § 615.5250 to include references to the regulatory capital standards in proposed part 628;

- In § 615.5255, the addition of part 628 capital standards and minor nonsubstantive and technical changes;

- In § 615.5270, revision to incorporate restrictions and limits on redemptions of equities would be included in tier 1 and tier 2 capital in the proposed rule;

- In § 615.5290, minor nonsubstantive and technical changes;

- Removal of part 615, subpart K, which contains the requirements for the

core surplus, total surplus, and net collateral standards;

- In §§ 615.5350, 615.5352, and 615.5355, replacement of references to core surplus, total surplus, and net collateral with references to tier 1 and tier 2 capital;
- In § 615.5357, addition of a reference to the capital restoration plan in proposed § 628.301; and
- Revision of § 620.17 to expand the stockholder notification requirement to include the regulatory capital standards in proposed part 628.

VII. Proposed Timeframe for Implementation

Basel III and the Federal regulatory banking agencies' rules have numerous phase-in and transition periods for the capital regulations lasting from 2014 (2015 for banking organizations not using the advanced approaches rules) until 2019 or after. Many of these transition provisions pertain to regulatory deductions and adjustments, minority interests, and temporary inclusion of non-qualifying instruments. There is also a transition period for the capital conservation buffer.

The FCA is not proposing any transition or phase-in periods for regulatory adjustments and deductions. The Federal regulatory banking agencies' transition periods serve several purposes. The agencies, which are members of the BCBS, are generally following the transition and phase-in periods of Basel III and other countries' banking regulations. Since the primary competitors of many U.S. banking organizations are financial institutions that are regulated by foreign countries that are also following Basel III, there will be a level playing field among such competitors. In addition, the Federal regulatory banking agencies note that the various transition periods will give the banking organizations they regulate sufficient time to build capital to meet the new minimum requirements.

The FCA believes multiple transition periods of varying lengths for multiple adjustments and deductions could be unnecessarily burdensome for System institutions and for the FCA. Instead of a single learning curve and software re-tooling on the calculation of the new framework, institutions and FCA staff would have a new learning curve every 4 quarters for the first 4 or more years after the rule becomes effective.

We have analyzed every System institution's call report data, and we project that all System institutions would meet all the proposed minimum amounts for the CET1, tier 1 and total capital risk-based ratios if those requirements were in effect today. In

reviewing the capital components, we assumed that all institutions would adopt required bylaw provisions for inclusion of stock and allocated equities in tier 1 and tier 2 capital. We also assumed that no institutions that redeem allocated equities on a cycle of less than 10 years would extend their patronage redemption periods in order to include those equities in CET1 capital, but rather they would maintain existing patronage redemption periods and qualify allocated equities as tier 2 capital. For the risk weightings, we used a simple analysis. For System associations, we assumed the proposed risk weightings would not be materially different from existing risk weightings in the current regulations. For System banks, we believe that certain new risk weights or conversion factors could have a material impact but, taken collectively, the impacts should net against each other. For instance, System banks would need to hold additional capital for their unconditionally cancelable unfunded commitments, but they would hold less capital for their end-user derivative portfolios. In the proposed rule, the banks may use credit risk mitigation for the collateral posted to derivative counterparties that are not available to them under current regulations.

All System institutions would meet the 5.0 minimum tier 1 leverage ratio (including the 1.5-percent component of the ratio for URE and equivalents) if the proposed requirement were effective today. Our analysis indicates that the leverage ratio would not be a constraining ratio for System associations because of their strong capital levels. The leverage ratio for associations would be very similar to their tier 1 capital risk-based ratio because most of their assets are risk weighted at 100 percent. If the proposed rule were effective today, the current leverage ratios of System banks would, however, be closer to, but above, the proposed 5.0-percent tier 1 and a 1.5-percent URE and URE equivalents component of the minimum leverage ratio. The System banks' tier 1 leverage ratios would be significantly lower than their tier 1 risk-based ratios because a large portion of their loans are to their affiliated associations and are risk-weighted at 20 percent.

The FCA has decided to propose a transition period for the capital conservation buffer that would commence on January 1, 2016, with the buffer fully phased in beginning January 1, 2019. Unlike the adjustments and deductions transitions, the calculation of the capital conservation buffer would not change over the transition period,

and there would not be an additional burden to revise the calculation each year. Rather, the amount of the capital conservation buffer increases every year until fully phased in. The Federal regulatory banking agencies' capital conservation buffer rules also will be fully phased in as of January 1, 2019, but their transition period will begin in 2015. We expect our final rule will become effective for the reporting periods beginning in 2016.

In the event that some System institutions do not meet the tier 1 and tier 2 capital standards when the rules become effective, we are proposing to permit them to comply by submitting a capital restoration plan. The plan, which the institution would be required to submit within 20 days of the quarterend during which the new capital standards become effective, would describe how the institution proposes to achieve and maintain compliance with the new requirements, demonstrating progress towards meeting that goal. If the FCA did not approve the plan, the institution would have to revise and re-submit the plan. There is a list of factors in the proposed rule that the FCA would consider in evaluating a plan. They include: (1) Circumstances leading to the institution's decrease in capital and whether they were caused by the institution or by circumstances beyond the institution's control; (2) the institution's financial ratios (*e.g.*, capital, adverse assets, ALL) compared to those of its peers or industry norms; and (3) the institution's previous compliance practices; and (4) the views of the institution's directors and managers regarding the plan. If the capital restoration plan is adopted by the institution and approved by the FCA within 180 days of the quarterend in which the tier 1 and tier 2 capital requirements become effective, the institution will be deemed to be in compliance with the requirements.¹²⁵

VIII. Abbreviations

ABCP	Asset-Backed Commercial Paper
ABS	Asset-backed Security
ADC	Acquisition, Development, or Construction
AFS	Available For Sale
ALL	Allowance for Loan Losses
AOC	Accumulated Other Comprehensive Income
BCBS	Basel Committee on Banking Supervision
BHC	Bank Holding Company
CCF	Credit Conversion Factor

¹²⁵ This proposed rule is modeled after current § 615.5336, which was adopted in 1997 at the time the FCA adopted the core surplus, total surplus, and net collateral requirements. Several System institutions achieved initial compliance with those requirements.

CCP Central Counterparty
 CDS Credit Default Swap
 CEIO Credit-Enhancing Interest-Only Strip
 CEM Current Exposure Method
 CFR Code of Federal Regulations
 CFPB Consumer Financial Protection Bureau
 CFTC Commodity Futures Trading Commission
 CPSS Committee on Payment and Settlement Systems
 CRC Country Risk Classifications
 CUSIP Committee on Uniform Securities Identification Procedures
 DAC Deferred Acquisition Cost
 DCO Derivatives Clearing Organizations
 DTA Deferred Tax Asset
 DTL Deferred Tax Liability
 DvP Delivery-versus-Payment
 E Measure of Effectiveness
 EE Expected Exposure
 ERISA Employee Retirement Income Security Act of 1974
 FCA Farm Credit Administration
 FDIC Federal Deposit Insurance Corporation
 FDICIA Federal Deposit Insurance Corporation Improvement Act of 1991
 FFIEC Federal Financial Institutions Examination Council
 FHA Federal Housing Authority
 FHLB Federal Home Loan Bank
 FHLMC Federal Home Loan Mortgage Corporation
 FIRREA Financial Institutions, Reform, Recovery and Enforcement Act
 FMU Financial Market Utility
 FNMA Federal National Mortgage Association
 FR Federal Register
 GAAP Generally Accepted Accounting Principles (U.S.)
 GNMA Government National Mortgage Association
 GSE Government-Sponsored Enterprise
 HAMP Home Affordable Mortgage Program
 HOLA Home Owners' Loan Act
 HTM Held to Maturity
 HVCRE High-Volatility Commercial Real Estate
 IFRS International Financial Reporting Standards
 IOSCO International Organization of Securities Commissions
 LTV Loan-to-Value Ratio
 MBS Mortgage-backed Security
 MDB Multilateral Development Bank
 MHC Mutual Holding Company
 MSA Mortgage Servicing Assets
 NRSRO Nationally Recognized Statistical Rating Organization
 OCC Office of the Comptroller of the Currency
 OECD Organization for Economic Cooperation and Development
 OFI Other Financing Institution
 OMB Office of Management and Budget
 OTC Over-the-Counter
 OTTI Other Than Temporary Impairment
 PFE Potential Future Exposure
 PMI Private Mortgage Insurance
 PMSR Purchased Mortgage Servicing Right
 PSE Public Sector Entities
 PVP Payment-versus-Payment
 QCCP Qualifying Central Counterparty
 QIS Quantitative Impact Study

QM Qualified Mortgage
 RBA Ratings-Based Approach
 RBC Risk-Based Capital
 REIT Real Estate Investment Trust
 Re-REMIC Resecuritization of Real Estate Mortgage Investment Conduit
 SAP Statutory Accounting Principles
 SEC Securities and Exchange Commission
 SFA Supervisory Formula Approach
 SLHC Savings and Loan Holding Company
 SPE Special Purpose Entity
 SRWA Simple Risk-Weight Approach
 SSFA Simplified Supervisory Formula Approach
 U.S.C. United States Code
 VA Department of Veterans Affairs
 VOBA Value of Business Acquired
 WAM Weighted Average Maturity

IX. Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*), the FCA hereby certifies that the proposed rule would not have a significant economic impact on a substantial number of small entities. Each of the banks in the Farm Credit System, considered together with its affiliated associations, has assets and annual income in excess of the amounts that would qualify them as small entities. Therefore, Farm Credit System institutions are not "small entities" as defined in the Regulatory Flexibility Act.

Addendum: Discussion of This Proposed Rule

Overview

The FCA is issuing a proposed rule (proposal or proposed rule) to update the capital rules for the System by adopting certain changes comparable to those suggested by the Basel Committee on Banking Supervision (BCBS) to the international regulatory capital framework, the Federal banking regulatory agencies' regulations, and requirements of the Dodd-Frank Act. Among other things, the proposed rule would:

- Establish minimum risk-based CET1, tier 1, and total capital ratio requirements;
- Establish a minimum tier 1 leverage ratio requirement;
- Establish a capital conservation buffer below which an institution's discretionary cash distributions and bonuses would be limited or prohibited without FCA approval;
- Increase capital requirements for past-due loans, high volatility commercial real estate exposures, and certain short-term loan commitments;
- Expand the recognition of collateral and guarantors in determining risk-weighted assets;
- Remove references to credit ratings;

- Establish due diligence requirements for securitization exposures; and
- Increase required regulatory capital disclosures of System banks.

This addendum summarizes this proposed rule. The FCA intends for this addendum to act as a guide for System institutions to navigate the proposed rule and identify the provisions that may be most relevant to them, but it is not comprehensive. The FCA expects and encourages all System institutions to review the proposed rule in its entirety.

We remind System institutions that the presence of a particular risk weighting does not itself provide authority for a System institution to have an exposure to that asset or item.

A. Capital Components

1. Common Equity Tier 1 Capital (CET1)

(a) Common cooperative equities (purchased member stock, purchased participation certificates, and allocated equities) with the following key criteria (among others):

- Borrower stock (regardless of redemption or revivment period) up to the statutory minimum of \$1000 or 2 percent of the loan amount, whichever is less;
 - Equities are perpetual;
 - Equities subject to discretionary revivment or redemption are not retired for at least 10 years after issuance;
 - Equities can be retired only with FCA prior approval (unless it is the statutory minimum borrower stock requirement or unless the distribution meets "safe harbor" standards) and the System institution has a capitalization bylaw providing that it must obtain FCA approval prior to redeeming or revolving any equities it includes in CET1 before the end of the 10-year period;
 - Equities represent a claim subordinated to all preferred stock, all subordinated debt, and all liabilities of the institution in a receivership, liquidation, or similar proceeding; and
- (b) Unallocated retained earnings (URE).

The FCA is proposing to require System institutions to exclude AOCI from CET1.

2. Additional Tier 1 Capital (AT1)

Equities other than common cooperative equities (*i.e.*, equities issued primarily to third-party investors) that meet most of the CET1 criteria, except that AT1 capital equities represent a claim that ranks senior to all common cooperative equities in a receivership, liquidation, or similar proceeding.

3. Tier 2 Capital

(a) Equities, which may be common cooperative equities or equities held by third parties, not includable in Tier 1 with the following key criteria:

- Equities are perpetual or have an original maturity of at least 5 years;
- Equities subject to discretionary revolvment or redemption are not retired for at least 5 years after issuance; and
- Equities may not be redeemed or revolved prior to maturity or the end of the stated revolvment period without FCA prior approval (unless the distribution meets “safe harbor” standards);

(b) Subordinated debt that is not callable for at least 5 years and not subject to acceleration except in the event of a receivership, liquidation, or similar proceeding; and

(c) Allowance for losses (ALL) up to 1.25 percent of total risk-weighted assets.

4. Regulatory Adjustments and Deductions

(a) *Deductions from CET1 capital.*

- Goodwill, intangible assets, gains-on-sale in connection with a securitization exposure, and defined benefit pension fund net assets, all of which are net of associated deferred tax liabilities; and
- The System institution’s allocated equity investments in another System institution.

(b) *Deductions from regulatory capital using the corresponding deduction approach.*

- A System institution’s purchased equity investments in other System institutions must be deducted using the corresponding deduction approach.

This means that a System institution would make deductions from the component of capital for which the underlying instrument qualified if it were issued by the System institution itself.

5. FCA Prior Approval of Cash Patronage Refunds, Cash Dividend Payments, and Allocated Equity Redemptions; “Safe Harbor” Treatment for Certain Such Payments

FCA prior approval would be required for redemption of equities included in tier 1 and tier 2, comparable to Basel III and the banking agencies’ rule. Prior approval is also required for cash dividends and cash patronage in excess of a specified level, comparable to U.S. banking law and regulations. An exception to the FCA prior approval requirement is that System institutions could retire member stock up to an

amount equal to the Farm Credit Act’s minimum member-borrower stock requirement of \$1,000 or 2 percent of the member’s loan, whichever is less. In addition, this amount of borrower stock would not have to be outstanding for a minimum period of 10 years in order for the institution to include it in CET1. However, redemptions of such amounts of stock would be included in the calculation for the “safe harbor” in proposed § 628.22(f)(5).

Under the proposed “safe harbor,” FCA prior approval is deemed to be granted (*i.e.*, a request for approval does not have to be made to the FCA) for cash distributions to pay dividends, patronage, or revolvments and redemptions of common cooperative equities provided that:

(a) For revolvments or redemptions of common cooperative equities included in CET1 capital, such equities were issued or allocated at least 10 years ago;

(b) For revolvments or redemptions of common cooperative equities included in Tier 2 capital, such equities were issued or allocated at least 5 years ago;

(c) After such cash distributions, the dollar amount of the System institution’s CET1 capital equals or exceeds the dollar amount of CET1 capital on the same date of the previous calendar year; and

(d) After such cash distributions, the System institution continues to comply with all minimum regulatory capital requirements and supervisory or enforcement actions.

6. Capital Conservation Buffer

The capital conservation buffer of 2.5 percent provides a cushion above regulatory capital minimums. The buffer’s purpose is to restrict an institution’s discretionary distributions of earnings before that institution reaches the minimum capital requirements.

If a System institution’s CET1, tier 1 and total capital ratios exceed minimum requirements, the capital conservation buffer is proposed to be the lowest of the following:

- The System institution’s CET1 capital ratio minus the System institution’s minimum CET1 capital ratio of 4.5 percent;
- The System institution’s tier 1 capital ratio minus the System institution’s minimum tier 1 capital ratio of 6 percent; and
- The System institution’s total capital ratio minus the System institution’s minimum total capital ratio of 8 percent.

If the CET1 ratio, tier 1 ratio, or total capital ratio does not exceed minimum requirements, then the capital conservation buffer would be zero.

B. Risk Weightings

1. Zero-Percent (0%) Risk-Weighted Exposures

- An exposure to the U.S. Government, its central bank, or a U.S. Government agency—§ 628.32(a)(1)(i)(A);
- The portion of an exposure that is directly and unconditionally guaranteed by the U.S. Government, its central bank, or a U.S. Government agency—§ 628.32(a)(1)(i)(B);
- An exposure to a sovereign entity that meets certain criteria (as discussed below)—§ 628.32(a) and Table 1;
 - Exposures to certain supranational entities and multilateral development banks—§ 628.32(b);
 - Cash—§ 628.32(l);
 - Certain gold bullion—§ 628.32(l);
 - Certain exposures that arise from the settlement of cash transactions with a central counterparty—§ 628.32(l);
 - An exposure to an OTC derivative contract that meets certain criteria—§ 628.37(b)(3)(i);
 - The collateralized portion of an exposure with respect to which the financial collateral meets certain criteria—§ 628.37(b)(3)(iii); and
 - An equity exposure to any entity whose credit exposures receive a 0-percent risk weight—§ 628.52(b)(1).

2. Twenty-Percent (20%) Risk-Weighted Exposures

- The portion of an exposure that is conditionally guaranteed by the U.S. Government, its central bank, or a U.S. Government agency—§ 628.32(a)(1)(ii);
- An exposure to a sovereign entity that meets certain criteria (as discussed below)—§ 628.32(a) and Table 1;
 - An exposure to a GSE, other than an equity exposure or preferred stock—§ 628.32(c)(1);
 - Most exposures to U.S.- or state-organized depository institutions or credit unions, including those that are OFIs—§ 628.32(d)(1);
 - An exposure to a foreign bank that meets certain criteria (as discussed below)—§ 628.32(d)(2) and Table 2;
 - A general obligation exposure to a U.S. or state PSE—§ 628.32(e)(1)(i);
 - An exposure to a non-U.S. PSE that meets certain criteria (as discussed below)—§ 628.32(e)(2), (e)(3), and (e)(4)(i) and Table 3;
 - Cash items in the process of collection—§ 628.32(l)(2);
 - A loan that a System bank makes to an association (a direct loan)—§ 628.32(m); and

- An equity exposure to a PSE or the Federal Agricultural Mortgage Corporation (Farmer Mac)—§ 628.52(b)(2).

3. Fifty-Percent (50%) Risk-Weighted Exposures

- An exposure to a sovereign entity that meets certain criteria (as discussed below)—§ 628.32(a) and Table 1;
- An exposure to a foreign bank that meets certain criteria (as discussed below)—§ 628.32(d)(2) and Table 2;
- A revenue obligation exposure to a U.S. or state PSE—§ 628.32(e)(1)(ii);
- An exposure to a non-U.S. PSE that meets certain criteria (as discussed below)—§ 628.32(e)(2), (e)(3), (e)(4)(ii) and Tables 3 and 4; and
- First lien residential mortgage exposures that meet certain criteria—§ 628.32(g).

4. One Hundred-Percent (100%) Risk-Weighted Exposures

- An exposure to a sovereign entity that meets certain criteria (as discussed below)—§ 628.32(a) and Table 1;
- Preferred stock issued by a GSE—§ 628.32(c)(2);
- An exposure to a foreign bank that meets certain criteria (as discussed below)—§ 628.32(d)(2) and Table 2;
- An exposure to a non-U.S. PSE that meets certain criteria (as discussed below)—§ 628.32(e)(2), (e)(3), (e)(5) and Tables 3 and 4;
- All corporate exposures—§ 628.32(f). This category would include the following:
 - Borrower loans such as agricultural loans and consumer loans, regardless of the corporate form, of the borrower, unless those loans qualify for different risk weights under other risk-weighting provisions;
 - System bank exposures to OFIs that do not satisfy the criteria for a 20-percent risk weight; and
 - Premises, fixed assets, and other real estate owned;
 - All residential mortgage exposures that do not satisfy the criteria for a 50-percent risk weight—§ 628.32(g);
 - DTAs arising from temporary differences that could be realized through net operating loss carrybacks—§ 628.32(l)(3);
 - All MSAs—§ 628.32(l)(4);
 - All assets that are not specifically assigned a different risk weight and that are not deducted from tier 1 or tier 2 capital pursuant to § 628.22—§ 628.32(l)(5);
 - Certain equity exposures authorized under § 615.5140(e)—§ 628.52(b)(3)(i);
 - The effective portion of a hedge pair—§ 628.52(b)(3)(ii); and
 - Non-significant equity exposures—§ 628.52(b)(3)(iii).

5. One Hundred Fifty-Percent (150%) Risk-Weighted Exposures

- An exposure to a sovereign entity that meet certain criteria (as discussed below)—§ 628.32(a) and Table 1;
- A sovereign exposure, if an event of sovereign default has occurred during the previous 5 years—§ 628.32(a)(6) and Table 1;
- An exposure to a foreign bank, if an event of sovereign default has occurred during the previous 5 years in the foreign bank's home country—§ 628.32(d)(2)(iv) and Table 2;
- An exposure to a non-U.S. PSE that meets certain criteria (as discussed below)—§ 628.32(e)(2), (e)(3), (e)(5) and Tables 3 and 4;
- An exposure to a PSE, if an event of sovereign default has occurred during the previous 5 years in the PSE's home country—§ 628.32(e)(6) and Tables 3 and 4;
- HVCRE exposures—§ 628.32(j); and
- The portion of a past due exposure that is not guaranteed or that is not secured by financial collateral (except for a sovereign exposure or a residential mortgage exposure, both risk-weighted as discussed above)—§ 628.32(k).

6. Six Hundred-Percent (600%) Risk-Weighted Exposures

- An equity exposure to an investment firm, provided that the investment firm meets specified conditions—§ 628.52(b).

7. One Thousand Two Hundred Fifty-Percent (1,250%) Risk-Weighted Exposures

- Certain high-risk securitization exposures, such as CEIO strips—§§ 628.41–628.45.

8. Past Due Exposures (90 Days or More Past Due or in Nonaccrual Status)

- One hundred (100) percent—residential mortgage exposures—§ 628.32(g);
- A System institution may assign a risk weight to the guaranteed portion of a past due exposure based on the risk weight that applies under § 628.36 if the guarantee or credit derivative meets the requirements of that section—§ 628.32(k)(2);
- A System institution may assign a risk weight to the portion of a past due exposure that is collateralized by financial collateral based on the risk weight that applies under § 628.37 if the financial collateral meets the requirements of that section—§ 628.32(k)(3); and
- One hundred fifty (150) percent—all other past due exposures—§ 628.32(k).

9. Conversion Factors for Off-Balance Sheet Items—§ 628.33

- Zero percent (0%)—the unused portion of a commitment that is unconditionally cancellable by the System institution;
- Twenty percent (20%)—
 - Commitment with an original maturity of 14 months or less that is not unconditionally cancellable by the System institution; and
 - Self-liquidating, trade-related contingent items that arise from the movement of goods, with an original maturity of 14 months or less;
- Fifty percent (50%)—
 - Commitments with an original maturity of more than 14 months that are not unconditionally cancellable by the System institution; and
 - Transaction-related contingent items, including performance bonds, bid bonds, warranties, and performance standby letters of credit;
- One hundred percent (100%)—
 - Guarantees;
 - Repurchase agreements (the off-balance sheet component of which equals the sum of the current fair values of all positions the System institution has sold subject to repurchase);
 - Credit-enhancing representations and warranties that are not securitization exposures;
 - Off-balance sheet securities lending transactions (the off-balance sheet component of which equals the sum of the current fair values of all positions the System institution has lent under the transaction);
 - Off-balance sheet securities borrowing transactions (the off-balance sheet component of which equals the sum of the current fair values of all non-cash positions the System institution has posted as collateral under the transaction);
 - Financial standby letters of credit; and
 - Forward agreements.

10. Over-the-Counter (OTC) Derivative Contracts—§ 628.34

The System institution would determine the risk-based capital requirement for a derivative contract by determining the exposure amount and then assigning a risk weight based on the counterparty or collateral. The exposure amount is the sum of current exposure plus potential future credit exposure (PFE). The current credit exposure is the greater of 0 or the mark-to-fair value of the derivative contract. The PFE is generally the notional amount of the derivative contract multiplied by a credit conversion factor for the type of derivative contract. Table

1 to proposed § 628.34 shows the credit conversion factors for derivative contracts.

11. Treatment of Cleared Transactions—§ 628.35

The proposal introduces a specific capital treatment for exposures to central counterparties (CCPs), including certain transactions conducted through clearing members by System institutions that are not themselves clearing members of a CCP. Proposed § 628.35 describes the capital treatment of cleared transactions and of default fund exposures to CCPs, including more favorable capital treatment for cleared transactions through CCPs that meet certain criteria.

12. Treatment of Guarantees—§ 628.36

The proposal would allow a System institution to substitute the risk weight of an eligible guarantor for the risk weight otherwise applicable to the guaranteed exposure. This treatment would apply only to *eligible guarantees* and *eligible credit derivatives*, and it would provide certain adjustments for maturity mismatches, currency mismatches, and situations where restructuring is not treated as a credit event. To be an *eligible guarantee*, the guarantee would be required to be from an *eligible guarantor* (as defined in the proposal) and would have to satisfy the definitional requirements of *eligible guarantee*.

13. Treatment of Collateralized Transactions—§ 628.37

The proposal allows System institutions to recognize the risk-mitigating benefits of financial collateral (as defined) in risk-weighted assets. In all cases, the System institution would be required to have a perfected, first priority interest in the financial collateral.

Where the collateral satisfies specified criteria, a System institution could use the simple approach—that is, it could apply a risk weight to the portion of an exposure that is secured by the fair value of financial collateral by using the risk weight of the collateral. There is a general risk weight floor of 20 percent.

For repo-style transactions, eligible margin loans, collateralized derivative contracts, and single-product netting sets of such transactions, a System institution could instead use the collateral haircut approach—that is, it could reduce the amount of exposure to be risk weighted (rather than substituting the risk weight of the collateral).

A System institution would be required to use the same approach for similar exposures or transactions.

14. Unsettled Transactions—§ 628.38

The proposal provides for a separate risk-based capital requirement for transactions involving securities, foreign exchange instruments, and commodities that have a risk of delayed settlement or delivery. The proposed capital requirement would not, however, apply to certain types of transactions, including cleared transactions that are marked-to-market daily and subject to daily receipt and payment of variation margin. The proposal contains separate treatments for delivery-versus-payment (DvP) and payment-versus-payment (PvP) transactions with a normal settlement period, and non-DvP/non-PvP transactions with a normal settlement period.

15. Securitization Exposures—§§ 628.41–628.45

The proposed rule introduces due diligence and other requirements for System institutions that own, originate, or purchase securitization exposures and introduces a new definition of securitization exposure. Under the proposed rule, a System institution that originates the underlying exposures included in a securitization could have a securitization exposure and, if so, would be subject to the requirements.

Note that mortgage-backed pass-through securities (for example, those guaranteed by FHLMC or FNMA) do not meet the proposed definition of a securitization exposure because they do not involve a tranching of credit risk. Rather, only those MBS that involve tranching of credit risk would be securitization exposures.

16. Equity Exposures—§§ 628.51–628.52

A System institution would apply a simple risk-weight approach (SRWA) to determine the risk weight for equity exposures that are not exposures to an investment fund.

17. Equity Exposures to Investment Funds—§ 628.53

The proposals described in this section would apply to equity exposures to investment funds such as mutual funds, but not to hedge funds or other leveraged investment funds. For exposures to investment funds (other than certain equity exposures authorized under § 615.5140(e), for which the risk-weighted asset amount is equal to their adjusted carrying value for the fund), a System institution must use

one of three risk-weighting approaches: The full-look through approach; the simple modified look-through approach; or the alternative modified look-through approach.

18. Foreign Exposures—§ 628.32(a), (d), and (e), and Tables 1, 2, 3, and 4

Under the proposal a System institution would risk weight an exposure to a foreign government, foreign public sector entity (PSE), and a foreign bank based on the Country Risk Classification (CRC) that is applicable to the foreign government, or the home country of the foreign PSE or foreign bank. If a foreign country does not have a CRC, the risk weighting for its government, PSEs, and banks would depend on whether or not the country is a member of the Organization for Economic Cooperation and Development (OECD). A sovereign exposure would be assigned a 150-percent risk weight immediately upon determining that an event of sovereign default has occurred, or if an event of sovereign default has occurred during the previous 5 years.

The risk weights for foreign sovereigns, foreign banks, and foreign PSEs are shown in the tables below:

TABLE 1—RISK WEIGHTS FOR FOREIGN SOVEREIGN EXPOSURES

	Risk weight (in percent)
Sovereign CRC:	
0–1	0
2	20
3	50
4–6	100
7	150
OECD Member with no CRC	0
Non-OECD Member with no CRC	100
Sovereign Default	150

TABLE 2—RISK WEIGHTS FOR EXPOSURES TO FOREIGN BANKS

	Risk weight (in percent)
Sovereign CRC:	
0–1	20
2	50
3	100
4–7	150
OECD Member with no CRC	20
Non-OECD Member with no CRC	100
Sovereign Default	150

TABLE 3—RISK WEIGHTS FOR FOREIGN PSE GENERAL OBLIGATIONS

	Risk weight (in percent)
Sovereign CRC:	
0–1	20
2	50
3	100
4–7	150
OECD Member with no CRC	20
Non-OECD Member with no CRC	100

TABLE 3—RISK WEIGHTS FOR FOREIGN PSE GENERAL OBLIGATIONS—Continued

	Risk weight (in percent)
Sovereign Default	150

TABLE 4—RISK WEIGHTS FOR FOREIGN PSE REVENUE OBLIGATIONS

	Risk weight (in percent)
Sovereign CRC:	
0–1	50
2–3	100
4–7	150
OECD Member with no CRC	50
Non-OECD Member with no CRC	100
Sovereign Default	150

TABLE 19—SUMMARY COMPARISON OF CURRENT RISK-WEIGHTING RULES VERSUS PROPOSED RISK-WEIGHTING RULES

Category	Current risk weight (in general)	Proposal	Comments
Risk weights for On-Balance Sheet Exposures Under Current and Proposed Rules			
Cash	0%	0%.	
Direct exposures to or unconditionally guaranteed by the U.S. Government, its central bank, or a U.S. Government agency.	0%	0%.	
Exposures to certain supranational entities and multilateral development banks.	20%	0%.	
Cash items in the process of collection.	20%	20%.	
Conditional exposures to the U.S. Government.	20%	20%.	A conditional exposure is one that requires the satisfaction of certain conditions, for example, servicing requirements.
Exposures to Government-sponsored entities (GSEs).	20% (including preferred stock) ...	20%—exposures other than preferred stock and equity exposures. 100%—preferred stock.	
Most exposures to U.S. depository institutions or credit unions (including those that are OFIs).	20%	20%.	
Exposures to U.S. public sector entities (PSEs).	20%—general obligations	20%—general obligations.	
	50%—revenue obligations	50%—revenue obligations..	
Exposures to other System institutions that are not deducted from tier 1 or tier 2 capital.	20%	20%.	
Corporate exposures (including exposures to OFIs that do not satisfy the criteria for a lower risk weight and agricultural borrowers).	100%	100%.	
High volatility commercial real estate (HVCRE) loans.	100% (not specifically addressed)	150%.	
Past due exposures	Generally no change when an exposure is past due. Past due QRLs—100%	100%—residential mortgage exposures. 150%—all other exposures, for the portion that is not guaranteed or secured by financial collateral.	90 days or more past due or in nonaccrual.
Servicing assets	100% (not specifically addressed) mortgage servicing assets (MSAs) and non-MSAs.	100%—MSAs. (Non-MSAs deducted from capital).	
Deferred tax assets	Certain DTAs deducted from capital. Other DTAs—100% (not specifically addressed).	100%—DTAs arising from temporary differences that could be realized through net operating carrybacks. (Other DTAs deducted from capital).	

TABLE 19—SUMMARY COMPARISON OF CURRENT RISK-WEIGHTING RULES VERSUS PROPOSED RISK-WEIGHTING RULES—Continued

Category	Current risk weight (in general)	Proposal	Comments
Assets not specifically assigned to a risk-weight category and not deducted from tier 1 or tier 2 capital.	100%	100%	Includes: —borrower loans such as agricultural loans and consumer loans, unless qualify for 50% risk weighting. —premises, fixed assets, and other real estate owned.
Exposures to foreign governments and their central banks.	0% for direct and unconditional claims on OECD governments. 20% for conditional claims on OECD governments. 100% for claims on non-OECD governments.	Risk weight depends on Country Risk Classification (CRC) applicable to the sovereign. If there is no CRC, depends on OECD membership. Risk weights range between 0% and 150%. 150% for a sovereign that has defaulted within the previous 5 years.	
Exposures to foreign banks	20% for claims on banks in OECD countries. 20% for short-term claims on banks in non-OECD countries. 100% for long-term claims on banks in non-OECD countries.	Risk weight depends on home country's CRC rating. If there is no CRC, depends on OECD membership of home country. Risk weights range between 20% and 150%. 150% in the case of a sovereign default in the bank's home country.	
Claims on foreign PSEs	20% for general obligations of states and political subdivisions of OECD countries. 50% for revenue obligations of states and political subdivisions of OECD countries. 100% for all obligations of states and political subdivisions of non-OECD countries.	Risk weight depends on the home country's CRC. If there is no CRC, risk depends on OECD membership of home country. Risk weights range between 20% and 150% for general obligations and between 50% and 150% for revenue obligations. 150% for a PSE in a home country with a sovereign default.	
MBS, ABS, and structured securities.	Ratings-based approach	Deduction for the after-tax gain-on-sale of a securitization. 1,250% risk weight for a CEIO. 100% for interest-only MBS that are not credit-enhancing. System institutions may elect to follow a gross up approach—senior securitization tranches are assigned the risk weight association with the underlying exposures. System institutions may instead elect to follow the simplified supervisory formula approach (SSFA)—requires various data inputs to a supervisory formula exposure. Alternatively, System institutions may apply a 1,250% risk weight to any securitization.	
Unsettled transactions	Not addressed.	100%, 625%, 937.5%, and 1,250% for DvP or PvP transactions depending on the number of business days past the settlement date. 1,250% for non-DvP, non-PvP transactions more than 5 days past the settlement date.	

TABLE 19—SUMMARY COMPARISON OF CURRENT RISK-WEIGHTING RULES VERSUS PROPOSED RISK-WEIGHTING RULES—Continued

Category	Current risk weight (in general)	Proposal	Comments
Equity exposures	100%	<p>The proposed capital requirement for unsettled transactions would not apply to cleared transactions that are marked-to-market daily and subject to daily receipt and payment of variation margin.</p> <p>0% risk weight: equity exposures to any entity whose credit exposures receive a 0% risk weight.</p> <p>20%: Equity exposures to a PSE or Farmer Mac.</p> <p>100%: Certain equity exposures authorized under § 615.5140(e), equity exposures to effective portions of hedge pairs, and equity exposures to non-significant equity investments.</p> <p>600%: Equity exposures to investment firms that satisfy certain conditions.</p>	
Equity exposures to investment funds.	There is a 20% risk weight floor on mutual fund holdings.	<p>Except for certain equity exposures authorized under § 615.5140(e), choose among three approaches: full look-through; simple modified look-through; and alternative modified look-through.</p> <p><i>Full look-through:</i> Risk weight the assets of the fund (as if owned directly) multiplied by the System institution's proportional ownership in the fund.</p> <p><i>Simple modified look-through:</i> Multiply the System institution's exposure by the risk weight of the highest risk weight asset in the fund.</p> <p><i>Alternative modified look-through:</i> Assign risk weight on a pro rata basis based on the investment limits in the fund's prospectus.</p> <p>For certain equity exposures authorized under § 615.5140(e), risk-weighted asset amount = adjusted carrying value.</p>	

Credit Conversion Factors (CCF) Under the Current and Proposed Rules

CCF for off-balance sheet items	<p>0% for the unused portion of a commitment with an original maturity of 14 months or less, or which is unconditionally cancellable by the System institution at any time.</p> <p>20% for short-term, self-liquidating, trade-related contingent items.</p> <p>50% for the unused portion of a commitment with an original maturity of more than 14 months that is not unconditionally cancellable by the System institution.</p>	<p>0% for the unused portion of a commitment that is unconditionally cancellable by the System institution.</p> <p>20% for the unused portion of a commitment with an original maturity of 14 months or less that is not unconditionally cancellable by the System institution.</p> <p>20% for self-liquidating trade-related contingent items that arise from the movement of goods, with an original maturity of 14 months or less.</p>	
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TABLE 19—SUMMARY COMPARISON OF CURRENT RISK-WEIGHTING RULES VERSUS PROPOSED RISK-WEIGHTING RULES—Continued

Category	Current risk weight (in general)	Proposal	Comments
<p>OTC derivative contracts (except cleared transactions).</p> <p>Cleared transactions</p>	<p>50% for transaction-related contingent items (performance bonds, bid bonds, warranties, and standby letters of credit).</p> <p>100% for guarantees, repurchase agreements, securities lending and borrowing transactions, financial standby letters of credit, and forward agreements.</p> <p>Calculation of off-balance sheet credit equivalents based on current exposure plus potential future exposure and a set of conversion factors.</p> <p>Not specifically addressed</p>	<p>50% for the unused portion of a commitment over 14 months that is not unconditionally cancellable by the System institution.</p> <p>50% for transaction-related contingent items (performance bonds, bid bonds, warranties, and standby letters of credit).</p> <p>100% for guarantees, repurchase agreements, securities lending and borrowing transactions, financial standby letters of credit, and forward agreements.</p> <p>Calculation of off-balance sheet credit equivalents amount based on current exposure plus potential future exposure and a revised set of conversion factors.</p> <p>Recognition of credit risk mitigation of collateralized OTC derivative contracts.</p> <p>If collateral posted with a qualified central counterparty, and subject to specific requirements, then assign 2 percent; or</p> <p>If requirements not met, then assign 4 percent.</p>	
Credit Risk Mitigation Under the Current and Proposed Rules			
<p>Guarantees</p> <p>Collateralized transactions</p>	<p>Generally recognizes guarantees provided by central governments, GSEs, PSEs in OECD countries, multilateral lending institutions, regional development institutions, U.S. depository institutions, foreign banks, and qualifying securities firms in OECD countries.</p> <p>No recognition</p>	<p>Recognizes guarantees from eligible guarantors, as defined.</p> <p>Substitution treatment allows the System institution to substitute the risk weight of the protection provider for the risk weight ordinarily assigned to the exposure.</p> <p>Applies only to eligible guarantees and eligible credit derivatives, and adjusts for maturity mismatches, currency mismatches, and where restructuring is not treated as a credit event.</p> <p>For financial collateral only, the proposal provides two approaches.</p> <p>1. <i>Simple approach</i></p> <p>A System institution may apply a risk weight to the portion of an exposure that is secured by the fair value of collateral by using the risk weight of the collateral—with a general risk weight floor of 20%.</p> <p>2. <i>Collateral haircut approach</i></p> <p>A System institution may use standard supervisory haircuts for eligible margin loans, repo-style transactions, and collateralized derivative contracts.</p>	<p>Claims conditionally guaranteed by the U.S. government receive a risk weight of 20 percent.</p> <p><i>Financial collateral</i> does not include does not include collateral such as real estate or chattel. In all cases the System institution must have a perfected, 1st priority interest.</p> <p>For the simple approach there must be a collateral agreement for at least the life of the exposure; collateral must be revalued at least every 6 months; collateral other than gold must be in the same currency.</p>

20. Disclosure Requirements—
§§ 628.61–628.63 (Including Tables 1–10)

The proposed rule would require each System bank, generally on a quarterly basis, to make public disclosures related to its capital requirements. Disclosures would be required as follows:

Table 1—Scope of Application—would provide the basic context underlying regulatory capital calculations.

Table 2—Capital Structure—would provide summary information on the terms and conditions of the main features of regulatory capital instruments. Would also require disclosure of the total amount of CET1, tier 1, and total capital, with separate disclosures for deductions and adjustments to capital.

Table 3—Capital Adequacy—would provide information on a System bank's approach for categorizing and risk-weighting its exposures, as well as the amount of total risk-weighted assets.

Table 4—Capital Conservation Buffer—would require a System bank to disclose the capital conservation buffer, the eligible retained income and any limitations on capital distributions and certain discretionary bonus payments, as applicable.

Table 5—Credit Risk: General Disclosures—would require a System bank to disclose information pertaining to its general credit risk.

Table 6—General Disclosure for Counterparty Credit Risk-Related Exposures—would require a System bank to disclose information pertaining to its counterparty credit risk.

Table 7—Credit Risk Mitigation—would require a System bank to disclose information pertaining to credit risk mitigation.

Table 8—Securitization—would provide information to market participants on the amount of credit risk transferred and retained by a System bank through securitization transactions, the types of products involved in the System bank's securitizations, the risks inherent in the System bank's securitized assets, the System bank's policies regarding credit risk mitigation, and the names of any entities that provide external credit assessments of a securitization.¹²⁶ Securitization transactions in which the originating System bank does not retain any securitization exposure would be shown separately and would only be

reported for the year of inception of the transaction.¹²⁷

Table 9—Equities—would provide market participants with an understanding of the types of equity securities held by the System bank and how they are valued. Would also provide information on the capital allocated to different equity products and the amount of unrealized gains and losses.

Table 10—Interest Rate Risk for Non-Trading Activities—would require a System bank to provide certain quantitative and qualitative disclosures regarding the System bank's management of interest rate risks.

List of Subjects

12 CFR Part 607

Accounting, Agriculture, Banks, banking, Reporting and recordkeeping requirements, Rural areas.

12 CFR Part 614

Agriculture, Banks, banking, Foreign trade, Reporting and recordkeeping requirements, Rural areas.

12 CFR Part 615

Accounting, Agriculture, Banks, banking, Government securities, Investments, Rural areas.

12 CFR Part 620

Accounting, Agriculture, Banks, banking, Reporting and recordkeeping requirements, Rural areas.

12 CFR Part 628

Accounting, Agriculture, Banks, banking, Capital, Government securities, Investments, Rural areas.

For the reasons stated in the preamble, parts 607, 614, 615, 620, and 628 of chapter VI, title 12 of the Code of Federal Regulations are proposed to be amended as follows:

PART 607—ASSESSMENT AND APPORTIONMENT OF ADMINISTRATIVE EXPENSES

■ 1. The authority citation for part 607 continues to read as follows:

Authority: Secs. 5.15, 5.17 of the Farm Credit Act (12 U.S.C. 2250, 2252) and 12 U.S.C. 3025.

■ 2. Section 607.2 is amended by revising paragraph (b) introductory text to read as follows:

§ 607.2 Definitions.

* * * * *

(b) *Average risk-adjusted asset base* means the average of the risk-adjusted asset base (as defined in § 615.5201 of this chapter) of banks, associations, and designated other System entities, calculated as follows:

* * * * *

PART 614—LOAN POLICIES AND OPERATIONS

■ 3. The authority citation for part 614 continues to read as follows:

Authority: 42 U.S.C. 4012a, 4104a, 4104b, 4106, and 4128; secs. 1.3, 1.5, 1.6, 1.7, 1.9, 1.10, 1.11, 2.0, 2.2, 2.3, 2.4, 2.10, 2.12, 2.13, 2.15, 3.0, 3.1, 3.3, 3.7, 3.8, 3.10, 3.20, 3.28, 4.12, 4.12A, 4.13B, 4.14, 4.14A, 4.14C, 4.14D, 4.14E, 4.18, 4.18A, 4.19, 4.25, 4.26, 4.27, 4.28, 4.36, 4.37, 5.9, 5.10, 5.17, 7.0, 7.2, 7.6, 7.8, 7.12, 7.13, 8.0, 8.5 of the Farm Credit Act (12 U.S.C. 2011, 2013, 2014, 2015, 2017, 2018, 2019, 2071, 2073, 2074, 2075, 2091, 2093, 2094, 2097, 2121, 2122, 2124, 2128, 2129, 2131, 2141, 2149, 2183, 2184, 2201, 2202, 2202a, 2202c, 2202d, 2202e, 2206, 2206a, 2207, 2211, 2212, 2213, 2214, 2219a, 2219b, 2243, 2244, 2252, 2279a, 2279a–2, 2279b, 2279c–1, 2279f, 2279f–1, 2279aa, 2279aa–5); sec. 413 of Pub. L. 100–233, 101 Stat. 1568, 1639.

■ 4. Section 614.4351 is amended by revising paragraph (a)(3) to read as follows:

§ 614.4351 Computation of lending and leasing limit base.

(a) * * *

(3) Any amounts of preferred stock not eligible to be included in tier 2 capital as defined in § 628.2 must be deducted from the lending limit base.

* * * * *

PART 615—FUNDING AND FISCAL AFFAIRS, LOAN POLICIES AND OPERATIONS, AND FUNDING OPERATIONS

■ 5. The authority citation for part 615 is revised to read as follows:

Authority: Secs. 1.5, 1.7, 1.10, 1.11, 1.12, 2.2, 2.3, 2.4, 2.5, 2.12, 3.1, 3.7, 3.11, 3.25, 4.3, 4.3A, 4.9, 4.14B, 4.25, 5.9, 5.17, 6.20, 6.26, 8.0, 8.3, 8.4, 8.6, 8.7, 8.8, 8.10, 8.12 of the Farm Credit Act (12 U.S.C. 2013, 2015, 2018, 2019, 2020, 2073, 2074, 2075, 2076, 2093, 2122, 2128, 2132, 2146, 2154, 2154a, 2160, 2202b, 2211, 2243, 2252, 2278b, 2278b–6, 2279aa, 2279aa–3, 2279aa–4, 2279aa–6, 2279aa–7, 2279aa–8, 2279aa–10, 2279aa–12); sec. 301(a), Pub. L. 100–233, 101 Stat. 1568, 1608; sec. 939A, Pub. L. 111–203, 124 Stat. 1326, 1887 (15 U.S.C. 78o–7 note).

■ 6. Section 615.5143 is amended by revising paragraphs (a)(3) and (b)(4) to read as follows:

§ 615.5143 Management of ineligible investments and reservation of authority to require divestiture.

(a) * * *

¹²⁶ For purposes of these disclosures (and these capital regulations), a System bank would be considered to have securitized assets if assets that it originated or purchased from third parties are included in a securitization.

¹²⁷ A System bank is authorized to act as an "originating System institution," which the proposed regulation would define as a System institution that directly or indirectly originated the underlying exposures included in a securitization.

(3) It must be excluded as collateral under § 615.5050.

(b) * * *

(4) You may continue to hold the investment as collateral under § 615.5050 at the lower of cost or market value.

* * * * *

■ 7. Sections 615.5200 and 615.5201 are revised to read as follows:

§ 615.5200 Capital planning.

(a) The Board of Directors of each System institution shall determine the amount of capital needed to assure the System institution's continued financial viability and to provide for growth necessary to meet the needs of its borrowers. The minimum capital standards specified in this part and part 628 of this chapter are not meant to be adopted as the optimal capital level in the System institution's capital adequacy plan. Rather, the standards are intended to serve as minimum levels of capital that each System institution must maintain to protect against the credit and other general risks inherent in its operations.

(b) Each Board of Directors shall establish, adopt, and maintain a formal written capital adequacy plan as a part of the financial plan required by § 618.8440 of this chapter. The plan shall include the capital targets that are necessary to achieve the System institution's capital adequacy goals as well as the minimum permanent capital, common equity tier 1 capital, tier 1 capital, total capital, and tier 1 leverage ratio (including the unallocated retained earnings (URE) and URE equivalents minimum) standards. The plan shall address any projected dividends, patronage distribution, equity retirements, or other action that may decrease the System institution's capital or the components thereof for which minimum amounts are required by this part. The plan shall set forth the circumstances in which retirements or revolvments of stock or equities may occur. In addition to factors that must be considered in meeting the minimum standards, the board of directors shall also consider at least the following factors in developing the capital adequacy plan:

- (1) Capability of management and the board of directors;
- (2) Quality of operating policies, procedures, and internal controls;
- (3) Quality and quantity of earnings;
- (4) Asset quality and the adequacy of the allowance for losses to absorb potential loss within the loan and lease portfolios;
- (5) Sufficiency of liquid funds;

(6) Needs of a System institution's customer base; and

(7) Any other risk-oriented activities, such as funding and interest rate risks, potential obligations under joint and several liability, contingent and off-balance-sheet liabilities or other conditions warranting additional capital.

§ 615.5201 Definitions.

For the purpose of this subpart, the following definitions apply:

Nonagreeing association means an association that does not have an allotment agreement in effect with a Farm Credit Bank or agricultural credit bank pursuant to § 615.5207(b)(2).

Permanent capital, subject to adjustments as described in § 615.5207, includes:

- (1) Current year earnings;
- (2) Allocated and unallocated earnings (which, in the case of earnings allocated in any form by a System bank to any association or other recipient and retained by the bank, must be considered, in whole or in part, permanent capital of the bank or of any such association or other recipient as provided under an agreement between the bank and each such association or other recipient);

(3) All surplus excluding accumulated other comprehensive income, except defined benefits pension fund net assets as reported under GAAP;

(4) Stock issued by a System institution, except:

(i) Stock that may be retired by the holder of the stock on repayment of the holder's loan, or otherwise at the option or request of the holder;

(ii) Stock that is protected under section 4.9A of the Act or is otherwise not at risk;

(iii) Farm Credit Bank equities required to be purchased by Federal land bank associations in connection with stock issued to borrowers that is protected under section 4.9A of the Act;

(iv) Capital subject to revolvment, unless:
(A) The bylaws of the System institution clearly provide that there is no express or implied right for such capital to be retired at the end of the revolvment cycle or at any other time; and

(B) The System institution clearly states in the notice of allocation that such capital may only be retired at the sole discretion of the board of directors in accordance with statutory and regulatory requirements and that no express or implied right to have such capital retired at the end of the revolvment cycle or at any other time is thereby granted;

(5) [Reserved]

(6) Financial assistance provided by the Farm Credit System Insurance Corporation that the FCA determines appropriate to be considered permanent capital; and

(7) Any other debt or equity instruments or other accounts the FCA has determined are appropriate to be considered permanent capital. The FCA may permit one or more System institutions to include all or a portion of such instrument, entry, or account as permanent capital, permanently or on a temporary basis, for purposes of this part.

Preferred stock means stock that is permanent capital and has dividend and/or liquidation preference over common stock.

Risk-adjusted asset base means standardized total risk-weighted assets as defined in § 628.2 of this chapter, adjusted in accordance with § 615.5207 and excluding the deduction for that amount of the System institution's allowance for loan losses that is not included in tier 2 capital.

Stock means stock and participation certificates.

System bank means a Farm Credit bank as defined in § 619.9140 of this chapter, which includes Farm Credit Banks, agricultural credit banks, and banks for cooperatives.

System institution means a System bank, an association of the Farm Credit System, Farm Credit Leasing Services Corporation, and their successors, and any other institution chartered by the FCA that the FCA determines should be considered a System institution for the purposes of this subpart.

Term preferred stock means preferred stock with an original maturity of at least 5 years and on which, if cumulative, the board of directors has the option to defer dividends, provided that, at the beginning of each of the last 5 years of the term of the stock, the amount that is eligible to be counted as permanent capital is reduced by 20 percent of the original amount of the stock (net of redemptions).

■ 8. Sections 615.5206, 615.5207, and 615.5208 are revised to read as follows:

§ 615.5206 Permanent capital ratio computation.

(a) The System institution's permanent capital ratio is determined on the basis of the financial statements of the System institution prepared in accordance with generally accepted accounting principles.

(b) The System institution's asset base and permanent capital are computed using average daily balances for the most recent 3 months.

(c) The System institution's permanent capital ratio is calculated by dividing the System institution's permanent capital, adjusted in accordance with § 615.5207 (the numerator), by the risk-adjusted asset base (the denominator) as defined in § 615.5201, to derive a ratio expressed as a percentage.

§ 615.5207 Capital adjustments and associated reductions to assets.

For the purpose of computing the System institution's permanent capital ratio, the following adjustments must be made prior to assigning assets to risk-weight categories and computing the ratio:

(a) Where two System institutions have stock investments in each other, such reciprocal holdings must be eliminated to the extent of the offset. If the investments are equal in amount, each System institution must deduct from its assets and its total capital an amount equal to the investment. If the investments are not equal in amount, each System institution must deduct from its total capital and its assets an amount equal to the smaller investment. The elimination of reciprocal holdings required by this paragraph must be made prior to making the other adjustments required by this section.

(b) Where an association has an equity investment in a Farm Credit bank, the double counting of capital is eliminated in the following manner:

(1) For a purchased investment, each association must deduct its investment in a System bank from its permanent capital. Each System bank will consider all purchased stock investments as its permanent capital.

(2) For an allocated investment, each System bank and each of its affiliated associations may enter into an agreement that specifies, for computing permanent capital, a dollar amount and/or percentage allotment of the association's allocated investment between the bank and the association. Section 615.5208 provides conditions for allotment agreements or defines allotments in the absence of such agreements.

(c) A Farm Credit Bank or agricultural credit bank and a recipient, other than an association, of allocated earnings from such bank may enter into an agreement specifying a dollar amount and/or percentage allotment of the recipient's allocated earnings in the bank between the bank and the recipient. Such agreement must comply with the provisions of paragraph (b) of this section, except that, in the absence of an agreement, the allocated investment must be allotted 100 percent

to the allocating bank and 0 percent to the recipient. All equities of the bank that are purchased by a recipient are considered as permanent capital of the issuing bank.

(d) A bank for cooperatives or an agricultural credit bank and a recipient of allocated earnings from such bank may enter into an agreement specifying a dollar amount and/or percentage allotment of the recipient's allocated earnings in the bank between the bank and the recipient. Such agreement must comply with the provisions of paragraph (b) of this section, except that, in the absence of an agreement, the allocated investment must be allotted 100 percent to the allocating bank and 0 percent to the recipient. All equities of a bank that are purchased by a recipient shall be considered as permanent capital of the issuing bank.

(e) Where a System institution has an equity investment in another System institution to capitalize a loan participation interest, the investing System institution must deduct from its permanent capital an amount equal to its investment in the participating System institution.

(f) Where a System institution has an equity investment in a service corporation chartered under section 4.25 of the Act or the Funding Corporation chartered under section 4.9 of the Act, the investing System institution must deduct from its permanent capital an amount equal to its investment in the service corporation or the Funding Corporation, respectively.

(g) Each System institution must deduct from its total capital an amount equal to all goodwill, whenever acquired.

(h) To the extent a System institution has deducted its investment in another System institution from its permanent capital, the investment may be eliminated from its asset base.

(i) Where a Farm Credit bank and an association have an enforceable written agreement to share losses on specifically identified assets on a predetermined quantifiable basis, such assets must be counted in each System institution's risk-adjusted asset base in the same proportion as the System institutions have agreed to share the loss.

(j) The permanent capital of a System institution must exclude any defined benefit pension fund net asset as reported under GAAP.

(k) For purposes of calculating capital ratios under this part, deferred-tax assets are subject to the conditions, limitations, and restrictions described in § 628.22(a)(3) of this chapter.

(l) [Reserved]

§ 615.5208 Allotment of allocated investments.

(a) The following conditions apply to agreements that a System bank enters into with an affiliated association pursuant to § 615.5207(b)(2):

(1) The agreement must be for a term of 1 year or longer.

(2) The agreement must be entered into on or before its effective date.

(3) The agreement may be amended according to its terms, but no more frequently than annually except in the event that a party to the agreement is merged or reorganized.

(4) On or before the effective date of the agreement, a certified copy of the agreement, and any amendments thereto, must be sent to the field office of the Farm Credit Administration responsible for examining the System institution. A copy must also be sent within 30 calendar days of adoption to the bank's other affiliated associations.

(5) Unless the parties otherwise agree, if the System bank and the association have not entered into a new agreement on or before the expiration of an existing agreement, the existing agreement will automatically be extended for another 12 months, unless either party notifies the Farm Credit Administration in writing of its objection to the extension prior to the expiration of the existing agreement.

(b) In the absence of an agreement between a System bank and one or more associations, or in the event that an agreement expires and at least one party has timely objected to the continuation of the terms of its agreement, the following formula applies with respect to the allocated investments held by those associations with which there is no agreement (nonagreeing associations), and does not apply to the allocated investments held by those associations with which the bank has an agreement (agreeing associations):

(1) The allotment formula must be calculated annually.

(2) The permanent capital ratio of the System bank must be computed as of the date that the existing agreement terminates, using a 3-month average daily balance, excluding the allocated investment from nonagreeing associations but including any allocated investments of agreeing associations that are allotted to the bank under applicable allocation agreements. The permanent capital ratio of each nonagreeing association must be computed as of the same date using a 3-month average daily balance, and must be computed excluding its allocated investment in the bank.

(3) If the permanent capital ratio for the System bank calculated in

accordance with § 615.5208(b)(2) is 7 percent or above, the allocated investment of each nonagreeing association whose permanent capital ratio calculated in accordance with § 615.5208(b)(2) is 7 percent or above must be allotted 50 percent to the bank and 50 percent to the association.

(4) If the permanent capital ratio of the System bank calculated in accordance with § 615.5208(b)(2) is 7 percent or above, the allocated investment of each nonagreeing association whose capital ratio is below 7 percent must be allotted to the association until the association's capital ratio reaches 7 percent or until all of the investment is allotted to the association, whichever occurs first. Any remaining unallotted allocated investment must be allotted 50 percent to the bank and 50 percent to the association.

(5) If the permanent capital ratio of the System bank calculated in accordance with § 615.5208(b)(2) is less than 7 percent, the amount of additional capital needed by the bank to reach a permanent capital ratio of 7 percent must be determined, and an amount of the allocated investment of each nonagreeing association must be allotted to the System bank, as follows:

(i) If the total of the allocated investments of all nonagreeing associations is greater than the additional capital needed by the bank, the allocated investment of each nonagreeing association must be multiplied by a fraction whose numerator is the amount of capital needed by the bank and whose denominator is the total amount of allocated investments of the nonagreeing associations, and such amount must be allotted to the bank. Next, if the permanent capital ratio of any nonagreeing association is less than 7 percent, a sufficient amount of unallotted allocated investment must then be allotted to each nonagreeing association, as necessary, to increase its permanent capital ratio to 7 percent, or until all such remaining investment is allotted to the association, whichever occurs first. Any unallotted allocated investment still remaining must be allotted 50 percent to the bank and 50 percent to the nonagreeing association.

(ii) If the additional capital needed by the bank is greater than the total of the allocated investments of the nonagreeing associations, all of the remaining allocated investments of the nonagreeing associations must be allotted to the bank.

§§ 615.5209, 615.5210, 615.5211, and 615.5212 [Removed and reserved]

■ 9. Sections 615.5209, 615.5210, 615.5211, and 615.5212 are removed and reserved.

■ 10. Section 615.5220 is revised to read as follows:

§ 615.5220 Capitalization bylaws.

(a) The board of directors of each System bank and association shall, pursuant to section 4.3A of the Farm Credit Act of 1971 (Act), adopt capitalization bylaws, subject to the approval of its voting shareholders that set forth:

(1) Classes of equities and the manner in which they shall be issued, transferred, converted and retired;

(2) For each class of equities, a description of the class(es) of persons to whom such stock may be issued, voting rights, dividend rights and preferences, and priority upon liquidation, including rights, if any, to share in the distribution of the residual estate;

(3) The number of shares and par value of equities authorized to be issued for each class of equities. However, the bylaws need not state a number or value limit for these equities:

(i) Equities that are required to be purchased as a condition of obtaining a loan, lease, or related service.

(ii) Non-voting stock resulting from the conversion of voting stock due to repayment of a loan.

(iii) Non-voting equities that are issued to an association's funding bank in conjunction with any agreement for a transfer of capital between the association and the bank.

(iv) Equities resulting from the distribution of earnings.

(4) For Farm Credit Banks, agricultural credit banks (with respect to loans other than to cooperatives), and associations, the percentage or dollar amount of equity investment (which may be expressed as a range within which the board of directors may from time to time determine the requirement) that will be required to be purchased as a condition for obtaining a loan, which amount shall be not less than, 2 percent of the loan amount or \$1,000, whichever is less;

(5) For banks for cooperatives and agricultural credit banks (with respect to loans to cooperatives), the percentage or dollar amount of equity or guaranty fund investment (which may be expressed as a range within which the board may from time to time determine the requirement) that serves as a target level of investment in the bank for patronage-sourced business, which amount shall not be less than, 2 percent

of the loan amount or \$1,000, whichever is less;

(6) The manner in which equities will be retired, including a provision stating that equities other than those protected under section 4.9A of the Act are retireable at the sole discretion of the board, provided minimum permanent capital adequacy standards established in subpart H of this part are met;

(7) The manner in which earnings will be allocated and distributed, including the basis on which patronage refunds will be paid, which shall be in accord with cooperative principles; and

(8) For Farm Credit banks, the manner in which the capitalization requirements of the Farm Credit bank shall be allocated and equalized from time to time among its owners.

(b) The board of directors of each service corporation (including the Farm Credit Leasing Services Corporation) shall adopt capitalization bylaws, subject to the approval of its voting shareholders, that set forth the requirements of paragraphs (a)(1), (a)(2), and (a)(3) of this section to the extent applicable. Such bylaws shall also set forth the manner in which equities will be retired and the manner in which earnings will be distributed.

■ 11. Section 615.5240 is revised to read as follows:

§ 615.5240 Capital requirements.

(a) The capitalization bylaws shall enable the institution to meet the capital adequacy standards established under subpart H of this part, part 628 of this chapter, and the capital requirements established by the board of directors of the institution.

(b) In order to qualify as permanent capital, equities issued under the bylaws must meet the following requirements:

(1) Retirement must be solely at the discretion of the board of directors and not upon a date certain (other than the original maturity date of preferred stock) or upon the happening of any event, such as repayment of the loan, and not pursuant to any automatic retirement or revolvment plan;

(2) Retirement must be at not more than book value;

(3) The institution must have made the disclosures required by this subpart;

(4) For common stock and participation certificates, dividends must be noncumulative and payable only at the discretion of the board; and

(5) For cumulative preferred stock, the board of directors must have discretion to defer payment of dividends.

■ 12. Sections 615.5250 and 615.5255 are revised to read as follows:

§ 615.5250 Disclosure requirements for sales of borrower stock.

(a) For sales of borrower stock, which for this subpart means equities purchased as a condition for obtaining a loan, an institution must provide a prospective borrower with the following documents prior to loan closing:

(1) The institution's most recent annual report filed under part 620 of this chapter;

(2) The institution's most recent quarterly report filed under part 620 of this chapter, if more recent than the annual report;

(3) A copy of the institution's capitalization bylaws; and

(4) A written description of the terms and conditions under which the equity is issued. In addition to specific terms and conditions, the description must disclose:

(i) That the equity is an at-risk investment and not a compensating balance;

(ii) That the equity is retireable only at the discretion of the board of directors, consistent with the institution's bylaws, and only if minimum capital standards established under subpart H of this part and part 628 are met;

(iii) Whether the institution presently meets its minimum capital standards established under subpart H of this part and part 628;

(iv) Whether the institution knows of any reason the institution may not meet its capital standards on the next earnings distribution date; and

(v) The rights, if any, to share in patronage distributions.

(b) Notwithstanding the provisions of paragraph (a) of this section, no materials previously provided to a purchaser (except the disclosures required by paragraph (a)(4) of this section) need be provided again unless the purchaser requests such materials.

§ 615.5255 Disclosure and review requirements for sales of other equities.

(a) A bank, association, or service corporation must submit a proposed disclosure statement to the Farm Credit Administration (FCA) for review and clearance prior to the proposed sale of any other equities, which for this subpart means equities not purchased as a condition for obtaining a loan.

(b) An institution may not offer to sell other equities until a disclosure statement is reviewed and cleared by the FCA.

(c) A disclosure statement must include:

(1) All of the information required by part 620 of this chapter in the annual report to shareholders as of a date

within 135 days of the proposed sale.

An institution may incorporate by reference its most recent annual report to shareholders and the most recent quarterly report filed with the FCA in satisfaction of this requirement;

(2) The information required by

§ 615.5250(a)(3) and (a)(4); and

(3) A discussion of the intended use of the sale proceeds.

(d) An institution is not required to provide the materials identified in paragraphs (c)(1) and (c)(2) of this section to a purchaser who previously received them unless the purchaser requests it.

(e) For any class of stock where each purchaser and each subsequent transferee acquires at least \$250,000 of the stock and meets the definition of "accredited investor" or "qualified institutional buyer" contained in 17 CFR 230.501 and 230.144A (or successor provisions), a disclosure statement submitted pursuant to this section is deemed reviewed and cleared by the FCA and an institution may treat stock that meets all requirements of part 615 as permanent capital for the purpose of meeting the minimum permanent capital standards established under subpart H, unless the FCA notifies the institution to the contrary within 30 days of receipt of a complete disclosure statement submission. A complete disclosure statement submission includes the proposed disclosure statement plus any additional materials requested by the FCA.

(f) For all other issuances, a disclosure statement submitted pursuant to this section is deemed cleared by the FCA, and an institution may treat stock that meets all requirements of part 615 as permanent capital for the purpose of meeting the minimum permanent capital standards established under subpart H unless the FCA notifies the institution to the contrary within 60 days of receipt of a complete disclosure statement submission. A complete disclosure statement submission includes the proposed disclosure statement plus any additional materials requested by the FCA.

(g) Upon request, the FCA will inform the institution how it will treat the proposed issuance for other regulatory capital ratios or computations.

(h) No institution, officer, director, employee, or agent shall, in connection with the sale of equities, make any disclosure, through a disclosure statement or otherwise, that is inaccurate or misleading, or omit to make any statement needed to prevent other disclosures from being misleading.

(i) Each bank and association must establish a method to disclose and make

information on insider preferred stock purchases and retirements readily available to the public. At a minimum, each institution offering preferred stock must make this information available upon request.

(j) The requirements of this section do not apply to the sale of Farm Credit System institution equities to:

(1) Other Farm Credit System institutions,

(2) Other financing institutions in connection with a lending or discount relationship, or

(3) Non-Farm Credit System lenders that purchase equities in connection with a loan participation transaction.

(k) In addition to the requirements of this section, each institution is responsible for ensuring its compliance with all applicable Federal and state securities laws.

■ 13. Section 615.5270 is revised to read as follows:

§ 615.5270 Retirement of other equities.

(a) Equities other than eligible borrower stock shall be retired at not more than their book value.

(b) Subject to the redemption restrictions in part 628 of this chapter, no equities shall be retired, except pursuant to §§ 615.5280 and 615.5290 or term stock at its stated maturity, unless after retirement the institution would continue to meet the minimum permanent capital standards established under subpart H of this part.

(c) A bank, association, or service corporation board of directors may delegate authority to retire at-risk stock to institution management if:

(1) The board has determined that the institution's capital position is adequate;

(2) All retirements are in accordance with applicable provisions of part 628 of this chapter and the institution's capital adequacy plan or capital restoration plan;

(3) The institution's permanent capital ratio will be in excess of 9 percent and the applicable capital conservation buffer set forth in § 628.11 of this chapter will be at or above 2.5 percent after any retirements;

(4) The institution will continue to satisfy all applicable regulatory capital standards after any retirements; and

(5) Management reports the aggregate amount and net effect of stock purchases and retirements to the board of directors each quarter.

(d) Each board of directors of a bank, association, or service corporation that issues preferred stock must adopt a written policy covering the retirement of preferred stock that complies with this paragraph and part 628 of this chapter

as applicable. The policy must, at a minimum:

(1) Establish any delegations of authority to retire preferred stock and the conditions of delegation, which must meet the requirements of paragraph (c) of this section and include minimum levels for regulatory capital standards as applicable and commensurate with the volatility of the preferred stock.

(2) Identify limitations on the amount of stock that may be retired during a single quarterly (or shorter) time period;

(3) Ensure that all stockholder requests for retirement are treated fairly and equitably;

(4) Prohibit any insider, including institution officers, directors, employees, or agents, from retiring any preferred stock in advance of the release of material non-public information concerning the institution to other stockholders; and

(5) Establish when insiders may retire their preferred stock.

(e) The institution's board must review its policy at least annually to ensure that it continues to be appropriate for the institution's current financial condition and consistent with its long-term goals established in its capital adequacy plan.

■ 14. Section 615.5290 is revised to read as follows:

§ 615.5290 Retirement of capital stock and participation certificates in event of restructuring.

(a) If a Farm Credit Bank or agricultural credit bank forgives and writes off, under § 617.7415 of this chapter, any of the principal outstanding on a loan made to any borrower, where appropriate the Federal land bank association of which the borrower is a member and stockholder shall cancel the same dollar amount of borrower stock held by the borrower in respect of the loan, up to the total amount of such stock, and to the extent provided for in the bylaws of the Bank relating to its capitalization, the Farm Credit Bank or agricultural credit bank shall retire an equal amount of stock owned by the Federal land bank association.

(b) If an association forgives and writes off, under § 617.7415 of this chapter, any of the principal outstanding on a loan made to any borrower, the association shall cancel the same dollar amount of borrower stock held by the borrower in respect of the loan, up to the total amount of such loan.

(c) Notwithstanding paragraphs (a) and (b) of this section, the borrower shall be entitled to retain at least one

share of stock to maintain the borrower's membership and voting interest.

Subpart K [Removed and reserved]

■ 15. Subpart K, consisting of §§ 615.5301, 615.5330, 615.5335, and 615.5336, is removed and reserved.

■ 16. Section 615.5350 is amended by revising paragraph (a) to read as follows:

§ 615.5350 General—applicability.

(a) The rules and procedures specified in this subpart are applicable to a proceeding to establish required minimum capital ratios that would otherwise be applicable to an institution under §§ 615.5205 and 628.10 of this chapter. The Farm Credit Administration is authorized to establish such minimum capital requirements for an institution as the Farm Credit Administration, in its discretion, deems to be necessary or appropriate in light of the particular circumstances of the institution. Proceedings under this subpart also may be initiated to require an institution having capital ratios greater than those set forth in §§ 615.5205 or 628.10 of this chapter to continue to maintain those higher ratios.

* * * * *

■ 17. Section 615.5352 is amended by revising paragraph (a) to read as follows:

§ 615.5352 Procedures.

(a) *Notice.* When the Farm Credit Administration determines that minimum capital ratios greater than those set forth in §§ 615.5205 or 628.10 of this chapter are necessary or appropriate for a particular institution, the Farm Credit Administration will notify the institution in writing of the proposed minimum capital ratios and the date by which they should be reached (if applicable) and will provide an explanation of why the ratios proposed are considered necessary or appropriate for the institution.

* * * * *

■ 18. Section 615.5354 is revised to read as follows:

§ 615.5354 Enforcement.

An institution that does not have or maintain the minimum capital ratios applicable to it, whether required in subpart H of this part and part 628 of this chapter, in a decision pursuant to this subpart, in a written agreement or temporary or final order under part C of title V of the Act, or in a condition for approval of an application, or an institution that has failed to submit or comply with an acceptable plan to attain those ratios, will be subject to

such administrative action or sanctions as the Farm Credit Administration considers appropriate. These sanctions may include the issuance of a capital directive pursuant to subpart M of this part or other enforcement action, assessment of civil money penalties, and/or the denial or condition of applications.

■ 19. Section 615.5355 is amended by revising paragraph (a) introductory text to read as follows:

§ 615.5355 Purpose and scope.

(a) This subpart is applicable to proceedings by the Farm Credit Administration to issue a capital directive under sections 4.3(b) and 4.3A(e) of the Act. A capital directive is an order issued to an institution that does not have or maintain capital at or greater than the minimum ratios set forth in §§ 615.5205 and 628.10 of this chapter; or established for the institution under subpart L of this part, by a written agreement under part C of title V of the Act, or as a condition for approval of an application. A capital directive may order the institution to:

* * * * *

PART 620—DISCLOSURE TO SHAREHOLDERS

■ 20. The authority citation for part 620 continues to read as follows:

Authority: Secs. 4.3, 4.3A, 4.19, 5.9, 5.17, 5.19 of the Farm Credit Act (12 U.S.C. 2154, 2154a, 2207, 2243, 2252, 2254); sec. 424 of Pub. L. 100–233, 101 Stat. 1568, 1656; sec. 514 of Pub. L. 102–552, 106 Stat. 4102.

■ 21. Section 620.5 is amended by revising paragraph (d)(1)(ix) to read as follows:

§ 620.5 Contents of the annual report to shareholders.

* * * * *

(d) * * *

(1) * * *

(ix) The statutory and regulatory restriction regarding retirement of stock and distribution of earnings pursuant to § 615.5215, and any requirements to add capital under a plan approved by the Farm Credit Administration pursuant to §§ 615.5350, 615.5351, 615.5353, or 615.5357 of this chapter.

* * * * *

■ 22. Section 620.17 is revised to read as follows:

§ 620.17 Special notice provisions for events related to noncompliance with minimum regulatory capital ratios.

(a) For purposes of this section, “regulatory capital ratios” include the capital ratios specified in § 628.10 of this chapter and the permanent capital

standard prescribed under § 615.5205 of this chapter.

(b) When a Farm Credit bank or association determines that it is not in compliance with one or more applicable minimum regulatory capital ratios, that institution must prepare and provide to its shareholders and the FCA a notice stating that the institution has initially determined it is not in compliance with the minimum regulatory capital ratio or ratios. Such notice must be given within 30 days following the monthend.

(c) When notice is given under paragraph (b) of this section, the institution must also notify its shareholders and the FCA when the regulatory capital ratio or ratios that are the subject of such notice decrease by one half of 1 percent or more from the level reported in the original notice, or from that reported in a subsequent notice provided under this paragraph. This notice must be given within 45 days following the end of every quarter at which the institution's regulatory capital ratio or ratios decreases as specified.

(d) Each institution required to prepare a notice under paragraph (b) or (c) of this section shall provide the notice to shareholders or publish it in any publication with circulation wide enough to be reasonably assured that all of the institution's shareholders have access to the information in a timely manner. The information required to be included in this notice must be conspicuous, easily understandable, and not misleading.

(e) A notice, at a minimum, shall include:

(1) A statement that:

(i) Briefly describes the regulatory capital ratios established by the FCA and the notice requirement of paragraph (b) of this section;

(ii) Indicates the institution's current level of capital; and

(iii) Notifies shareholders that the institution's capital is below the FCA minimum regulatory capital ratio or ratios.

(2) A statement of the effect that noncompliance has had on the institution and its shareholders, including whether the institution is currently prohibited by statute or regulation from retiring stock or distributing earnings or whether the FCA has issued a capital directive or other enforcement action to the institution.

(3) A complete description of any event(s) that may have significantly contributed to the institution's noncompliance with the minimum regulatory capital ratio or ratios.

(4) A statement that the institution is required by regulation to provide another notice to shareholders within 45 days following the end of any subsequent quarter at which the regulatory capital ratio or ratios decrease by one half of 1 percent or more from the level reported in the notice.

■ 23. Part 628 is added to read as follows:

PART 628—CAPITAL ADEQUACY OF SYSTEM INSTITUTIONS

Subpart A—General Provisions

Sec.

628.1 Purpose, applicability, and reservations of authority.

628.2 Definitions.

628.3 Operational requirements for certain exposures.

628.4–628.9 [Reserved]

Subpart B—Capital Ratio Requirements and Buffers

628.10 Minimum capital requirements.

628.11 Capital conservation buffer.

628.12–628.19 [Reserved]

Subpart C—Definition of Capital

628.20 Capital components and eligibility criteria for regulatory capital instruments.

628.21 [Reserved]

628.22 Regulatory capital adjustments and deductions.

628.23 Limits on third party capital.

628.24–628.29 [Reserved]

Subpart D—Risk-Weighted Assets—Standardized Approach

628.30 Applicability.

Risk-Weighted Assets for General Credit Risk

628.31 Mechanics for calculating risk-weighted assets for general credit risk.

628.32 General risk weights.

628.33 Off-balance sheet exposures.

628.34 OTC derivative contracts.

628.35 Cleared transactions.

628.36 Guarantees and credit derivatives: substitution treatment.

628.37 Collateralized transactions.

Risk-Weighted Assets for Unsettled Transactions

628.38 Unsettled transactions.

628.39 through 628.40 [Reserved]

Risk-Weighted Assets for Securitization Exposures

628.41 Operational requirements for securitization exposures.

628.42 Risk-weighted assets for securitization exposures.

628.43 Simplified supervisory formula approach (SSFA) and the gross-up approach.

628.44 Securitization exposures to which the SSFA and gross-up approach do not apply.

628.45 Recognition of credit risk mitigants for securitization exposures.

Risk-Weighted Assets for Equity Exposures

628.51 Introduction and exposure measurement.

628.52 Simple risk-weight approach (SRWA).

628.53 Equity exposures to investment funds.

628.54 through 628.60 [Reserved]

Disclosures

628.61 Purpose and scope.

628.62 Disclosure requirements.

628.63 Disclosures.

628.64 through 628.99 [Reserved]

Subpart E—[Reserved]

Subpart F—[Reserved]

Subpart G—Transition Provisions

628.300 Transitions.

628.301 Initial compliance and reporting requirements.

Authority: Secs. 1.5, 1.7, 1.10, 1.11, 1.12, 2.2, 2.3, 2.4, 2.5, 2.12, 3.1, 3.7, 3.11, 3.25, 4.3, 4.3A, 4.9, 4.14B, 4.25, 5.9, 5.17, 6.20, 6.26, 8.0, 8.3, 8.4, 8.6, 8.7, 8.8, 8.10, 8.12 of the Farm Credit Act (12 U.S.C. 2013, 2015, 2018, 2019, 2020, 2073, 2074, 2075, 2076, 2093, 2122, 2128, 2132, 2146, 2154, 2154a, 2160, 2202b, 2211, 2243, 2252, 2278b, 2278b–6, 2279aa, 2279aa–3, 2279aa–4, 2279aa–6, 2279aa–7, 2279aa–8, 2279aa–10, 2279aa–12); sec. 301(a), Pub. L. 100–233, 101 Stat. 1568, 1608; sec. 939A, Pub. L. 111–203, 124 Stat. 1326, 1887 (15 U.S.C. 780–7 note).

Subpart A—General Provisions

§ 628.1 Purpose, applicability, and reservations of authority.

(a) *Purpose.* This part establishes minimum capital requirements and overall capital adequacy standards for System institutions. This part includes methodologies for calculating minimum capital requirements, public disclosure requirements related to the capital requirements, and transition provisions for the application of this part.

(b) *Limitation of authority.* Nothing in this part limits the authority of FCA to take action under other provisions of law, including action to address unsafe or unsound practices or conditions, deficient capital levels, or violations of law or regulation, under part C of title V of the Farm Credit Act.

(c) *Applicability.* Subject to the requirements in paragraph (d) of this section:

(1) *Minimum capital requirements and overall capital adequacy standards.* Each System institution must calculate its minimum capital requirements and meet the overall capital adequacy standards in subpart B of this part.

(2) *Regulatory capital.* Each System institution must calculate its regulatory capital in accordance with subpart C of this part.

(3) *Risk-weighted assets.* (i) Each System institution must use the

methodologies in subpart D of this part to calculate total risk-weighted assets.

(ii) [Reserved]

(4) *Disclosures.* (i) All System banks must make the public disclosures described in subpart D of this part.

(ii) [Reserved]

(iii) [Reserved]

(d) *Reservation of authority*—(1)

Additional capital in the aggregate. FCA may require a System institution to hold an amount of regulatory capital greater than otherwise required under this part if FCA determines that the System institution's capital requirements under this part are not commensurate with the System institution's credit, market, operational, or other risks according to part 615, subparts L and M of this chapter.

(2) *Regulatory capital elements.* (i) If FCA determines that a particular common equity tier 1 (CET1), additional tier 1 (AT1), or tier 2 capital element has characteristics or terms that diminish its permanence or its ability to absorb losses, or otherwise present safety and soundness concerns, FCA may require the System institution to exclude all or a portion of such element from CET1 capital, AT1 capital, or tier 2 capital, as appropriate.

(ii) Notwithstanding the criteria for regulatory capital instruments set forth in subpart C of this part, FCA may find that a capital element may be included in a System institution's CET1 capital, AT1 capital, or tier 2 capital on a permanent or temporary basis consistent with the loss absorption capacity of the element and in accordance with § 628.20(e).

(3) *Risk-weighted asset amounts.* If FCA determines that the risk-weighted asset amount calculated under this part by the System institution for one or more exposures is not commensurate with the risks associated with those exposures, FCA may require the System institution to assign a different risk-weighted asset amount to the exposure(s) or to deduct the amount of the exposure(s) from its regulatory capital.

(4) *Total leverage.* If FCA determines that the leverage exposure amount, or the amount reflected in the System institution's reported average total consolidated assets, for a balance sheet exposure calculated by a System institution under § 628.10 is inappropriate for the exposure(s) or the circumstances of the System institution, FCA may require the System institution to adjust this exposure amount in the numerator and the denominator for purposes of the leverage ratio calculations.

(5) [Reserved]

(6) *Other reservation of authority.*

With respect to any deduction or limitation required under this part, FCA may require a different deduction or limitation, provided that such alternative deduction or limitation is commensurate with the System institution's risk and consistent with safety and soundness.

(e) *Notice and response procedures.* In making a determination under this section, FCA will apply notice and response procedures in the same manner as the notice and response procedures in § 615.5352 of this chapter.

(f) [Reserved]

§ 628.2 Definitions.

As used in this part:

Additional tier 1 capital (AT1) is defined in § 628.20(c).

Allocated equities (stock or surplus) means a retained patronage refund that a System institution has distributed to a borrower.¹

Allocated investment means earnings allocated but not paid in cash by a System bank to an association or other recipient.

Allowances for loan losses (ALL) means valuation allowances that have been established through a charge against earnings to cover estimated credit losses on loans, lease financing receivables, or other extensions of credit as determined in accordance with generally accepted accounting principles (GAAP). For purposes of this part, ALL includes allowances that have been established through a charge against earnings to cover estimated credit losses associated with off-balance sheet credit exposures as determined in accordance with GAAP.

Bank holding company means a bank holding company as defined in section 2 of the Bank Holding Company Act.

Bank Holding Company Act means the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841 *et seq.*).

Bankruptcy remote means, with respect to an entity or asset, that the entity or asset would be excluded from an insolvent entity's estate in receivership, insolvency, liquidation, or similar proceeding.

Borrower stock means the capital investment a borrower holds in a

¹ System institutions as cooperatives are required to send borrowers a written notice of allocation specifying the amount of patronage refunds retained as equity pursuant to the Internal Revenue Code section 1388. There are two types of allocated equities: Qualified allocated equities and nonqualified allocated equities. Allocated equities are redeemable at the System institution board's discretion. Allocated equities contain no voting rights and are generally subordinated to borrow stock in receivership, insolvency, liquidation, or similar proceeding.

System institution in connection with a loan.

Call Report means reports of condition and performance, as described in subpart D of part 621 of this chapter.

Carrying value means, with respect to an asset, the value of the asset on the balance sheet of the System institution, determined in accordance with GAAP.

Central counterparty (CCP) means a counterparty (for example, a clearinghouse) that facilitates trades between counterparties in one or more financial markets by either guaranteeing trades or novating contracts.

CFTC means the U.S. Commodity Futures Trading Commission.

Clean-up call means a contractual provision that permits an originating System institution or servicer to call securitization exposures before their stated maturity or call date.

Cleared transaction means an exposure associated with an outstanding derivative contract or repo-style transaction that a System institution or clearing member has entered into with a central counterparty (that is, a transaction that a central counterparty has accepted).

(1) The following transactions are cleared transactions:

(i) [Reserved]

(ii) [Reserved]

(iii) A transaction between a clearing member client System institution and a clearing member where the clearing member acts as a financial intermediary on behalf of the clearing member client and enters into an offsetting transaction with a CCP, provided that the requirements set forth in § 628.3(a) are met; or

(iv) A transaction between a clearing member client System institution and a CCP where a clearing member guarantees the performance of the clearing member client System institution to the CCP and the transaction meets the requirements of § 628.3(a)(2) and (a)(3).

(2) [Reserved]

Clearing member means a member of, or direct participant in, a CCP that is entitled to enter into transactions with the CCP.

Clearing member client means a party to a cleared transaction associated with a CCP in which a clearing member either acts as a financial intermediary with respect to the party or guarantees the performance of the party to the CCP.

Collateral agreement means a legal contract that specifies the time when, and circumstances under which, a counterparty is required to pledge collateral to a System institution for a single financial contract or for all

financial contracts in a netting set and confers upon the System institution a perfected, first-priority security interest (notwithstanding the prior security interest of any custodial agent), or the legal equivalent thereof, in the collateral posted by the counterparty under the agreement. This security interest must provide the System institution with a right to close out the financial positions and liquidate the collateral upon an event of default of, or failure to perform by, the counterparty under the collateral agreement. A contract would not satisfy this requirement if the System institution's exercise of rights under the agreement may be stayed or avoided under applicable law in the relevant jurisdictions, other than in receivership, conservatorship, resolution under the Federal Deposit Insurance Act, title II of the Dodd-Frank Act, under any similar insolvency law applicable to GSEs, or under the Farm Credit Act.

Commitment means any legally binding arrangement that obligates a System institution to extend credit or to purchase assets.

Commodity derivative contract means a commodity-linked swap, purchased commodity-linked option, forward commodity-linked contract, or any other instrument linked to commodities that gives rise to similar counterparty credit risks.

Commodity Exchange Act means the Commodity Exchange Act of 1936 (7 U.S.C. 1 *et seq.*).

Common cooperative equity or equities means borrower stock, participation certificates, and allocated equities issued or allocated by a System institution to its members.

Common equity tier 1 capital (CET1) is defined in § 628.20(b).

Company means a corporation, partnership, limited liability company, depository institution, business trust, special purpose entity, System institution, association, or similar organization.

Corporate exposure means an exposure to a company that is not:

- (1) An exposure to a sovereign, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, a multi-lateral development bank (MDB), a depository institution, a foreign bank, a credit union, or a public sector entity (PSE);
- (2) An exposure to a GSE;
- (3) A residential mortgage exposure;
- (4) [Reserved];
- (5) [Reserved];
- (6) A high volatility commercial real estate (HVGRE) exposure;
- (7) A cleared transaction;
- (8) [Reserved];

- (9) A securitization exposure;
- (10) An equity exposure;
- (11) An unsettled transaction; or
- (12) An exposure to another System institution.

Country risk classification (CRC) with respect to a sovereign, means the most recent consensus CRC published by the Organization for Economic Cooperation and Development (OECD) as of December 31st of the prior calendar year that provides a view of the likelihood that the sovereign will service its external debt.

Credit derivative means a financial contract executed under standard industry credit derivative documentation that allows one party (the protection purchaser) to transfer the credit risk of one or more exposures (reference exposure(s)) to another party (the protection provider) for a certain period of time.

Credit-enhancing interest-only strip (CEIO) means an on-balance sheet asset that, in form or in substance:

- (1) Represents a contractual right to receive some or all of the interest and no more than a minimal amount of principal due on the underlying exposures of a securitization; and
- (2) Exposes the holder of the CEIO to credit risk directly or indirectly associated with the underlying exposures that exceeds a pro rata share of the holder's claim on the underlying exposures, whether through subordination provisions or other credit-enhancement techniques.

Credit-enhancing representations and warranties means representations and warranties that are made or assumed in connection with a transfer of underlying exposures (including loan servicing assets) and that obligate a System institution to protect another party from losses arising from the credit risk of the underlying exposures. Credit-enhancing representations and warranties include provisions to protect a party from losses resulting from the default or nonperformance of the counterparties of the underlying exposures or from an insufficiency in the value of the collateral backing the underlying exposures. Credit-enhancing representations and warranties do not include:

- (1) Early default clauses and similar warranties that permit the return of, or premium refund clauses covering, 1–4 family residential first mortgage loans that qualify for a 50-percent risk weight for a period not to exceed 120 days from the date of transfer. These warranties may cover only those loans that were originated within 1 year of the date of transfer;

(2) Premium refund clauses that cover assets guaranteed, in whole or in part, by the U.S. Government, a U.S. Government agency or a Government-sponsored enterprise (GSE), provided the premium refund clauses are for a period not to exceed 120 days from the date of transfer; or

(3) Warranties that permit the return of underlying exposures in instances of misrepresentation, fraud, or incomplete documentation.

Credit risk mitigant means collateral, a credit derivative, or a guarantee.

Credit union means an insured credit union as defined under the Federal Credit Union Act (12 U.S.C. 1752 *et seq.*).

Current exposure means, with respect to a netting set, the larger of 0 or the fair value of a transaction or portfolio of transactions within the netting set that would be lost upon default of the counterparty, assuming no recovery on the value of the transactions. Current exposure is also called replacement cost.

Current exposure methodology means the method of calculating the exposure amount for over-the-counter derivative contracts in § 628.34(a).

Custodian means a company that has legal custody of collateral provided to a CCP.

Depository institution means a depository institution as defined in section 3 of the Federal Deposit Insurance Act.

Depository institution holding company means a bank holding company or savings and loan holding company.

Derivative contract means a financial contract whose value is derived from the values of one or more underlying assets, reference rates, or indices of asset values or reference rates. Derivative contracts include interest rate derivative contracts, exchange rate derivative contracts, equity derivative contracts, commodity derivative contracts, credit derivative contracts, and any other instrument that poses similar counterparty credit risks. Derivative contracts also include unsettled securities, commodities, and foreign exchange transactions with a contractual settlement or delivery lag that is longer than the lesser of the market standard for the particular instrument or 5 business days.

Discretionary bonus payment means a payment made to a senior officer of a System institution, where:

- (1) The System institution retains discretion as to whether to make, and the amount of, the payment until the payment is awarded to the senior officer;

(2) The amount paid is determined by the System institution without prior promise to, or agreement with, the senior officer; and

(3) The senior officer has no contractual right, whether express or implied, to the bonus payment.

Dodd-Frank Act means the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Pub. L. 111–203, 124 Stat. 1376).

Early amortization provision means a provision in the documentation governing a securitization that, when triggered, causes investors in the securitization exposures to be repaid before the original stated maturity of the securitization exposures, unless the provision:

(1) Is triggered solely by events not directly related to the performance of the underlying exposures or the originating System institution (such as material changes in tax laws or regulations); or

(2) Leaves investors fully exposed to future draws by borrowers on the underlying exposures even after the provision is triggered.

Effective notional amount means, for an eligible guarantee or eligible credit derivative, the lesser of the contractual notional amount of the credit risk mitigant and the exposure amount of the hedged exposure, multiplied by the percentage coverage of the credit risk mitigant.

Eligible clean-up call means a clean-up call that:

(1) Is exercisable solely at the discretion of the originating System institution or servicer;

(2) Is not structured to avoid allocating losses to securitization exposures held by investors or otherwise structured to provide credit enhancement to the securitization; and

(3)(i) For a traditional securitization, is only exercisable when 10 percent or less of the principal amount of the underlying exposures or securitization exposures (determined as of the inception of the securitization) is outstanding; or

(ii) For a synthetic securitization, is only exercisable when 10 percent or less of the principal amount of the reference portfolio of underlying exposures (determined as of the inception of the securitization) is outstanding.

Eligible credit derivative means a credit derivative in the form of a credit default swap, nth-to-default swap, total return swap, or any other form of credit derivative approved by the FCA, provided that:

(1) The contract meets the requirements of an eligible guarantee and has been confirmed by the

protection purchaser and the protection provider;

(2) Any assignment of the contract has been confirmed by all relevant parties;

(3) If the credit derivative is a credit default swap or nth-to-default swap, the contract includes the following credit events:

(i) Failure to pay any amount due under the terms of the reference exposure, subject to any applicable minimal payment threshold that is consistent with standard market practice and with a grace period that is closely in line with the grace period of the reference exposure; and

(ii) Receivership, insolvency, liquidation, conservatorship or inability of the reference exposure issuer to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due, and similar events;

(4) The terms and conditions dictating the manner in which the contract is to be settled are incorporated into the contract;

(5) If the contract allows for cash settlement, the contract incorporates a robust valuation process to estimate loss reliably and specifies a reasonable period for obtaining post-credit event valuations of the reference exposure;

(6) If the contract requires the protection purchaser to transfer an exposure to the protection provider at settlement, the terms of at least one of the exposures that is permitted to be transferred under the contract provide that any required consent to transfer may not be unreasonably withheld;

(7) If the credit derivative is a credit default swap or nth-to-default swap, the contract clearly identifies the parties responsible for determining whether a credit event has occurred, specifies that this determination is not the sole responsibility of the protection provider, and gives the protection purchaser the right to notify the protection provider of the occurrence of a credit event; and

(8) If the credit derivative is a total return swap and the System institution records net payments received on the swap as net income, the System institution records offsetting deterioration in the value of the hedged exposure (either through reductions in fair value or by an addition to reserves).

Eligible guarantee means a guarantee from an eligible guarantor that:

(1) Is written;

(2) Is either:

(i) Unconditional, or

(ii) A contingent obligation of the U.S. Government or its agencies, the enforceability of which is dependent upon some affirmative action on the

part of the beneficiary of the guarantee or a third party (for example, meeting servicing requirements);

(3) Covers all or a pro rata portion of all contractual payments of the obligated party on the reference exposure;

(4) Gives the beneficiary a direct claim against the protection provider;

(5) Is not unilaterally cancelable by the protection provider for reasons other than the breach of the contract by the beneficiary;

(6) Except for a guarantee by a sovereign, is legally enforceable against the protection provider in a jurisdiction where the protection provider has sufficient assets against which a judgment may be attached and enforced;

(7) Requires the protection provider to make payment to the beneficiary on the occurrence of a default (as defined in the guarantee) of the obligated party on the reference exposure in a timely manner without the beneficiary first having to take legal actions to pursue the obligor for payment; and

(8) Does not increase the beneficiary's cost of credit protection on the guarantee in response to deterioration in the credit quality of the reference exposure.

Eligible guarantor means:

(1) A sovereign, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, a Federal Home Loan Bank, Federal Agricultural Mortgage Corporation (Farmer Mac), a multilateral development bank (MDB), a depository institution, a bank holding company, a savings and loan holding company, a credit union, a foreign bank, or a qualifying central counterparty; or

(2) An entity (other than a special purpose entity):

(i) That at the time the guarantee is issued or anytime thereafter, has issued and outstanding an unsecured debt security without credit enhancement that is investment grade;

(ii) Whose creditworthiness is not positively correlated with the credit risk of the exposures for which it has provided guarantees; and

(iii) That is not an insurance company engaged predominately in the business of providing credit protection (such as a monoline bond insurer or re-insurer).

Eligible margin loan means:

(1) An extension of credit where:

(i) The extension of credit is collateralized exclusively by liquid and readily marketable debt or equity securities, or gold;

(ii) The collateral is marked-to-fair value daily, and the transaction is subject to daily margin maintenance requirements; and

(iii) The extension of credit is conducted under an agreement that provides the System institution the right to accelerate and terminate the extension of credit and to liquidate or set-off collateral promptly upon an event of default, including upon an event of receivership, insolvency, liquidation, conservatorship, or similar proceeding, of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions, other than in receivership, conservatorship, resolution under the Federal Deposit Insurance Act, Title II of the Dodd-Frank Act, under any similar insolvency law applicable to GSEs, or under the Farm Credit Act.²

(2) In order to recognize an exposure as an eligible margin loan for purposes of this subpart, a System institution must comply with the requirements of § 628.3(b) with respect to that exposure.

Eligible servicer cash advance facility means a servicer cash advance facility in which:

(1) The servicer is entitled to full reimbursement of advances, except that a servicer may be obligated to make non-reimbursable advances for a particular underlying exposure if any such advance is contractually limited to an insignificant amount of the outstanding principal balance of that exposure;

(2) The servicer's right to reimbursement is senior in right of payment to all other claims on the cash flows from the underlying exposures of the securitization; and

(3) The servicer has no legal obligation to, and does not make advances to the securitization if the servicer concludes the advances are unlikely to be repaid.

Equity derivative contract means an equity-linked swap, purchased equity-linked option, forward equity-linked contract, or any other instrument linked to equities that gives rise to similar counterparty credit risks.

Equity exposure means:

(1) A security or instrument (whether voting or non-voting) that represents a direct or an indirect ownership interest in, and is a residual claim on, the assets and income of a company, unless:

(i) The issuing company is consolidated with the System institution under GAAP;

(ii) The System institution is required to deduct the ownership interest from tier 1 or tier 2 capital under this part;

(iii) The ownership interest incorporates a payment or other similar obligation on the part of the issuing company (such as an obligation to make periodic payments); or

(iv) The ownership interest is a securitization exposure;

(2) A security or instrument that is mandatorily convertible into a security or instrument described in paragraph (1) of this definition;

(3) An option or warrant that is exercisable for a security or instrument described in paragraph (1) of this definition; or

(4) Any other security or instrument (other than a securitization exposure) to the extent the return on the security or instrument is based on the performance of a security or instrument described in paragraph (1) of this definition.

ERISA means the Employee Retirement Income and Security Act of 1974 (29 U.S.C. 1001 *et seq.*).

Exchange rate derivative contract means a cross-currency interest rate swap, forward foreign-exchange contract, currency option purchased, or any other instrument linked to exchange rates that gives rise to similar counterparty credit risks.

Exposure means an amount at risk.

Exposure amount means:

(1) For the on-balance sheet component of an exposure (other than an available-for-sale or held-to-maturity security; an OTC derivative contract; a repo-style transaction or an eligible margin loan for which the System institution determines the exposure amount under § 628.37; a cleared transaction; or a securitization exposure), the System institution's carrying value of the exposure.

(2) For a security (that is not a securitization exposure, equity exposure, or preferred stock classified as an equity security under GAAP) classified as available-for-sale or held-to-maturity, the System institution's carrying value (including net accrued but unpaid interest and fees) for the exposure less any net unrealized gains on the exposure and plus any net unrealized losses on the exposure.

(3) For available-for-sale preferred stock classified as an equity security under GAAP, the System institution's carrying value of the exposure less any net unrealized gains on the exposure that are reflected in such carrying value but excluded from the System institution's regulatory capital components.

(4) For the off-balance sheet component of an exposure (other than

an OTC derivative contract; a repo-style transaction or an eligible margin loan for which the System institution calculates the exposure amount under § 628.37; a cleared transaction; or a securitization exposure), the notional amount of the off-balance sheet component multiplied by the appropriate credit conversion factor (CCF) in § 628.33.

(5) For an exposure that is an OTC derivative contract, the exposure amount determined under § 628.34.

(6) For an exposure that is a cleared transaction, the exposure amount determined under § 628.35.

(7) For an exposure that is an eligible margin loan or repo-style transaction for which the bank calculates the exposure amount as provided in § 628.37, the exposure amount determined under § 628.37.

(8) For an exposure that is a securitization exposure, the exposure amount determined under § 628.42.

Farm Credit Act means the Farm Credit Act of 1971, as amended (12 U.S.C. 2001 *et seq.*).

Federal Deposit Insurance Act means the Federal Deposit Insurance Act (12 U.S.C. 1813).

Federal Deposit Insurance Corporation Improvement Act means the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401).

Financial collateral means collateral:

(1) In the form of:

(i) Cash on deposit at a depository institution or Federal Reserve Bank (including cash held for the System institution by a third-party custodian or trustee);

(ii) Gold bullion;

(iii) Long-term debt securities that are not resecuritization exposures and that are investment grade;

(iv) Short-term debt instruments that are not resecuritization exposures and that are investment grade;

(v) Equity securities that are publicly traded;

(vi) Convertible bonds that are publicly traded; or

(vii) Money market fund shares and other mutual fund shares if a price for the shares is publicly quoted daily; and

(2) In which the System institution has a perfected, first-priority security interest or, outside of the United States, the legal equivalent thereof (with the exception of cash on deposit at a depository institution or Federal Reserve Bank and notwithstanding the prior security interest of any custodial agent).

First-lien residential mortgage exposure means a residential mortgage exposure secured by a first lien.

² This requirement is met where all transactions under the agreement are (i) executed under U.S. law and (ii) constitute "securities contracts" under section 555 of the Bankruptcy Code (11 U.S.C. 555) or qualified financial contracts under section 11(e)(8) of the Federal Deposit Insurance Act.

Foreign bank means a foreign bank as defined in § 211.2 of the Federal Reserve Board's Regulation K (12 CFR 211.2) (other than a depository institution).

Forward agreement means a legally binding contractual obligation to purchase assets with certain drawdown at a specified future date, not including commitments to make residential mortgage loans or forward foreign exchange contracts.

GAAP means generally accepted accounting principles as used in the United States.

Gain-on-sale means an increase in the equity capital of a System institution (as reported on the Call Report) resulting from a traditional securitization (other than an increase in equity capital resulting from the System institution's receipt of cash in connection with the securitization or reporting of a mortgage servicing asset on the Call Report).

General obligation means a bond or similar obligation that is backed by the full faith and credit of a public sector entity (PSE).

Government-sponsored enterprise (GSE) means an entity established or chartered by the U.S. Government to serve public purposes specified by the U.S. Congress but whose debt obligations are not explicitly guaranteed by the full faith and credit of the U.S. Government. For purposes of part 628, this definition excludes System institutions.

Guarantee means a financial guarantee, letter of credit, insurance, or other similar financial instrument (other than a credit derivative) that allows one party (beneficiary) to transfer the credit risk of one or more specific exposures (reference exposure) to another party (protection provider).

High volatility commercial real estate (HVCRE) exposure means a credit facility that, prior to conversion to permanent financing, finances or has financed the acquisition, development, or construction (ADC) of real property, unless the facility finances:

- (1) One- to four-family residential properties;
- (2) Real property that:
 - (i) The FCA has authorized as an investment pursuant to § 615.5140(e) of this chapter; and
 - (ii) [Reserved];
- (3) The purchase or development of agricultural land, which includes all land known to be used or usable for agricultural purposes (such as crop and livestock production), provided that the valuation of the agricultural land is based on its value for agricultural purposes and the valuation does not take into consideration any potential use of the land for non-agricultural

commercial development or residential development; or

(4) Commercial real estate projects in which:

(i) The loan-to-value ratio is less than or equal to the maximum loan-to-value ratio set forth in § 614.4200(b) of this chapter;

(ii) The borrower has contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid development expenses out-of-pocket) of at least 15 percent of the real estate's appraised "as completed" value; and

(iii) The borrower contributed the amount of capital required by paragraph (4)(ii) of this definition before the System institution advances funds under the credit facility, and the capital contributed by the borrower, or internally generated by the project, is contractually required to remain in the project throughout the life of the project. The life of a project concludes only when the credit facility is converted to permanent financing or is sold or paid in full. Permanent financing may be provided by the System institution that provided the ADC facility as long as the permanent financing is subject to the System institution's underwriting criteria for long-term mortgage loans.

Home country means the country where an entity is incorporated, chartered, or similarly established.

Insurance company means an insurance company as defined in section 201 of the Dodd-Frank Act (12 U.S.C. 5381).

Insurance underwriting company means an insurance company as defined in section 201 of the Dodd-Frank Act (12 U.S.C. 5381) that engages in insurance underwriting activities.

Insured depository institution means an insured depository institution as defined in section 3 of the Federal Deposit Insurance Act.

Interest rate derivative contract means a single-currency interest rate swap, basis swap, forward rate agreement, purchased interest rate option, when-issued securities, or any other instrument linked to interest rates that gives rise to similar counterparty credit risks.

International Lending Supervision Act means the International Lending Supervision Act of 1983 (12 U.S.C. 3907).

Investment fund means a company:

(1) Where all or substantially all of the assets of the company are financial assets; and

(2) That has no material liabilities.

Investment grade means that the entity to which the System institution is exposed through a loan or security, or

the reference entity with respect to a credit derivative, has adequate capacity to meet financial commitments for the projected life of the asset or exposure. Such an entity or reference entity has adequate capacity to meet financial commitments if the risk of its default is low and the full and timely repayment of principal and interest is expected.

Junior-lien residential mortgage exposure means a residential mortgage exposure that is not a first-lien residential mortgage exposure.

Member means a borrower or former borrower from a System institution that holds voting or nonvoting common cooperative equities of the institution.

Money market fund means an investment fund that is subject to 17 CFR 270.2a-7 or any foreign equivalent thereof.

Mortgage servicing assets (MSAs) means the contractual rights owned by a System institution to service for a fee mortgage loans that are owned by others.

Multilateral development bank (MDB) means 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 U.S. Government is a shareholder or contributing member or which the FCA determines poses comparable credit risk.

National Bank Act means the National Bank Act (12 U.S.C. 24).

Netting set means a group of transactions with a single counterparty that are subject to a qualifying master netting agreement or a qualifying cross-product master netting agreement. For purposes of calculating risk-based capital requirements using the internal models methodology in subpart E of this part, this term does not cover a transaction:

(1) That is not subject to such a master netting agreement; or

(2) Where the System institution has identified specific wrong-way risk.

Nonqualified allocated equities means retained patronage refunds paid in the form of stock or surplus that are distributed to a borrower and that a System institution does not deduct from

its taxable income according to the Internal Revenue Code §§ 1382(b) and 1383.³

Nth-to-default credit derivative means a credit derivative that provides credit protection only for the nth-defaulting reference exposure in a group of reference exposures.

Operating entity means a company established to conduct business with clients with the intention of earning a profit in its own right and that generally produces goods or provides services beyond the business of investing, reinvesting, holding, or trading in financial assets. All System banks, associations, and service corporations, and all UBEs, are operating entities.

Original maturity with respect to an off-balance sheet commitment means the length of time between the date a commitment is issued and:

(1) For a commitment that is not subject to extension or renewal, the stated expiration date of the commitment; or

(2) For a commitment that is subject to extension or renewal, the earliest date on which the System institution can, at its option, unconditionally cancel the commitment.

Originating System institution, with respect to a securitization, means a System institution that:

(1) Directly or indirectly originated the underlying exposures included in the securitization; or

(2) [Reserved]

Other financing institution (OFI) means any entity referred to in section 1.7(b)(1)(B) of the Farm Credit Act.

Over-the-counter (OTC) derivative contract means a derivative contract that is not a cleared transaction.

Participation certificates means borrower stock held by a borrower that does not have voting rights.

Patronage refund means a declared distribution of capital to borrowers based on a System institution's net income and allocated to borrowers based on business conducted with the cooperative pursuant to the Internal Revenue Code section 1381(a). Patronage refunds may be distributed as cash, allocated equity (stock or surplus),

or a combination of cash and allocated equity.

Performance standby letter of credit (or performance bond) means an irrevocable obligation of a System institution to pay a third-party beneficiary when a customer (account party) fails to perform on any contractual nonfinancial or commercial obligation. To the extent permitted by law or regulation, performance standby letters of credit include arrangements backing, among other things; subcontractors' and suppliers' performance, labor; and materials contracts, and construction bids.

Protection amount (P) means, with respect to an exposure hedged by an eligible guarantee or eligible credit derivative, the effective notional amount of the guarantee or credit derivative, reduced to reflect any currency mismatch, maturity mismatch, or lack of restructuring coverage (as provided in § 628.36).

Publicly traded means traded on:

(1) Any exchange registered with the Securities and Exchange Commission (SEC) as a national securities exchange under section 6 of the Securities Exchange Act; or

(2) Any non-U.S.-based securities exchange that:

(i) Is registered with, or approved by, a national securities regulatory authority; and

(ii) Provides a liquid, two-way market for the instrument in question.

Public sector entity (PSE) means a state, local authority, or other governmental subdivision below the sovereign level.

Qualified allocated equities means patronage refunds distributed to a borrower, in the form of stock or surplus, that a System institution can exclude from its taxable income and that the borrower has agreed to include in its taxable income.⁴

Qualifying central counterparty (QCCP) means a central counterparty that:

(1)(i) Is a designated financial market utility (FMU), as defined in section 803 of the Dodd-Frank Act;

(ii) If not located in the United States, is regulated and supervised in a manner equivalent to a designated FMU; or

(iii) Meets the following standards:

(A) The central counterparty requires all parties to contracts cleared by the

counterparty to be fully collateralized on a daily basis;

(B) The System institution demonstrates to the satisfaction of the FCA that the central counterparty:

(1) Is in sound financial condition;

(2) Is subject to supervision by the Board, the CFTC, or the Securities Exchange Commission (SEC), or, if the central counterparty is not located in the United States, is subject to effective oversight by a national supervisory authority in its home country; and

(3) Meets or exceeds the risk-management standards for central counterparties set forth in regulations established by the Board, the CFTC, or the SEC under title VII or title VIII of the Dodd-Frank Act; or if the central counterparty is not located in the United States, meets or exceeds similar risk-management standards established under the law of its home country that are consistent with international standards for central counterparty risk management as established by the relevant standard setting body of the Bank of International Settlements; and

(2)(i) Provides the System institution with the central counterparty's hypothetical capital requirement or the information necessary to calculate such hypothetical capital requirement, and other information the System institution is required to obtain under § 628.35(d)(3);

(ii) Makes available to the FCA and the CCP's regulator the information described in paragraph (2)(i) of this definition; and

(iii) Has not otherwise been determined by the FCA to not be a QCCP due to its financial condition, risk profile, failure to meet supervisory risk management standards, or other weaknesses or supervisory concerns that are inconsistent with the risk weight assigned to qualifying central counterparties under § 628.35.

(3) A QCCP that fails to meet the requirements of a QCCP in the future may still be treated as a QCCP under the conditions specified in § 628.3(f).

Qualifying master netting agreement means a written, legally enforceable agreement provided that:

(1) The agreement creates a single legal obligation for all individual transactions covered by the agreement upon an event of default, including upon an event of receivership, insolvency, liquidation, or similar proceeding, of the counterparty;

(2) The agreement provides the System institution the right to accelerate, terminate, and close-out on a net basis all transactions under the agreement and to liquidate or set-off collateral promptly upon an event of

³Nonqualified allocated equities also include surplus in a tax-exempt institution or subsidiary. When a System institution redeems a nonqualified allocation, the System institution deducts the allocation from its taxable income, if any, and the borrower generally recognizes the tax liability, if any, as ordinary income. System institutions distribute two types of nonqualified allocated equities through written notices of allocation to the borrowers: (1) Those subject to redemption and (2) those not subject to redemption. The second type for GAAP purposes is considered an equivalent of unallocated surplus and consolidated with unallocated surplus on externally prepared shareholder reports.

⁴A System institution must pay at least 20 percent of a qualified patronage refund in cash to borrowers. A System institution must provide the borrowers with a qualified written notice of allocation when they distribute qualified patronage refunds pursuant to the Internal Revenue Code §§ 1381(b) and 1388(c). A System institution redeems qualified allocated equities according to a board-approved plan.

default, including upon an event of receivership, insolvency, liquidation, or similar proceeding, of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions, other than in receivership, conservatorship, resolution under the Federal Deposit Insurance Act, title II of the Dodd-Frank Act, under any similar insolvency law applicable to GSEs, or under the Farm Credit Act;

(3) The agreement does not contain a walkaway clause (that is, a provision that permits a non-defaulting counterparty to make a lower payment than it otherwise would make under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the agreement); and

(4) In order to recognize an agreement as a qualifying master netting agreement for purposes of this subpart, a System institution must comply with the requirements of § 628.3(d) with respect to that agreement.

Repo-style transaction means a repurchase or reverse repurchase transaction, or a securities borrowing or securities lending transaction, including a transaction in which the System institution acts as agent for a customer and indemnifies the customer against loss, provided that:

(1) The transaction is based solely on liquid and readily marketable securities, cash, or gold;

(2) The transaction is marked-to-fair value daily and subject to daily margin maintenance requirements;

(3)(i) The transaction is a “securities contract” or “repurchase agreement” under section 555 or 559, respectively, of the Bankruptcy Code (11 U.S.C. 555 or 559) or a qualified financial contract under section 11(e)(8) of the Federal Deposit Insurance Act; or

(ii) If the transaction does not meet the criteria set forth in paragraph (3)(i) of this definition, then either:

(A) The transaction is executed under an agreement that provides the System institution the right to accelerate, terminate, and close-out the transaction on a net basis and to liquidate or set-off collateral promptly upon an event of default, including upon an event of receivership, insolvency, liquidation, or similar proceeding, of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions, other than in receivership, conservatorship, resolution under the Federal Deposit Insurance Act, title II of

the Dodd-Frank Act, under any similar insolvency law applicable to GSEs, or under the Farm Credit Act; or

(B) The transaction is:

(1) Either overnight or unconditionally cancelable at any time by the System institution; and

(2) Executed under an agreement that provides the System institution the right to accelerate, terminate, and close-out the transaction on a net basis and to liquidate or set-off collateral promptly upon an event of counterparty default; and

(4) In order to recognize an exposure as a repo-style transaction for purposes of this subpart, a System institution must comply with the requirements of § 628.3(e) of this part with respect to that exposure.

Resecuritization means a securitization which has more than one underlying exposure and in which one or more of the underlying exposures is a securitization exposure.

Resecuritization exposure means:

(1) An on- or off-balance sheet exposure to a resecuritization; or

(2) An exposure that directly or indirectly references a resecuritization exposure.

Residential mortgage exposure means an exposure (other than a securitization exposure or equity exposure) that is:

(1) An exposure that is primarily secured by a first or subsequent lien on one-to-four family residential property, provided that the dwelling (including attached components such as garages, porches, and decks) represents at least 50 percent of the total appraised value of the collateral secured by the first or subsequent lien; or

(2)[Reserved]

Revenue obligation means a bond or similar obligation that is an obligation of a PSE, but which the PSE is committed to repay with revenues from the specific project financed rather than general tax funds.

Savings and loan holding company means a savings and loan holding company as defined in section 10 of the Home Owners' Loan Act (12 U.S.C. 1467a).

Securities and Exchange Commission (SEC) means the U.S. Securities and Exchange Commission.

Securities Exchange Act means the Securities Exchange Act of 1934 (15 U.S.C. 78).

Securitization exposure means:

(1) An on-balance sheet or off-balance sheet credit exposure (including credit-enhancing representations and warranties) that arises from a traditional securitization or synthetic securitization (including a resecuritization); or

(2) An exposure that directly or indirectly references a securitization

exposure described in paragraph (1) of this definition.

Securitization special purpose entity (securitization SPE) means a corporation, trust, or other entity organized for the specific purpose of holding underlying exposures of a securitization, the activities of which are limited to those appropriate to accomplish this purpose, and the structure of which is intended to isolate the underlying exposures held by the entity from the credit risk of the seller of the underlying exposures to the entity.

Senior officer means the Chief Executive Officer, the Chief Operations Officer, the Chief Financial Officer, the Chief Credit Officer, and the General Counsel, or persons in similar positions; and any other person responsible for a major policy-making function.

Servicer cash advance facility means a facility under which the servicer of the underlying exposures of a securitization may advance cash to ensure an uninterrupted flow of payments to investors in the securitization, including advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the underlying exposures.

Small Business Act means the Small Business Act (15 U.S.C. 632).

Small Business Investment Act means the Small Business Investment Act of 1958 (15 U.S.C. 682).

Sovereign means a central government (including the U.S. Government) or an agency, department, ministry, or central bank of a central government.

Sovereign default means noncompliance by a sovereign with its external debt service obligations or the inability or unwillingness of a sovereign government to service an existing loan according to its original terms, as evidenced by failure to pay principal and interest timely and fully, arrearages, or restructuring.

Sovereign exposure means:

(1) A direct exposure to a sovereign; or

(2) An exposure directly and unconditionally backed by the full faith and credit of a sovereign.

Standardized total risk-weighted assets means:

(1) The sum of:

(i) Total risk-weighted assets for general credit risk as calculated under § 628.31;

(ii) Total risk-weighted assets for cleared transactions as calculated under § 628.35;

(iii) Total risk-weighted assets for unsettled transactions as calculated under § 628.38;

(iv) Total risk-weighted assets for securitization exposures as calculated under § 628.42;

(v) Total risk-weighted assets for equity exposures as calculated under §§ 628.52 and 628.53; and

(vi) [Reserved]; minus

(2) Any amount of the System institution's allowance for loan losses that is not included in tier 2 capital.

Subsidiary means, with respect to a company, a company controlled by that company.

System bank means a Farm Credit bank as defined in § 619.9140 of this chapter, which includes Farm Credit Banks, agricultural credit banks, and banks for cooperatives.

System institution means a System bank, an association of the Farm Credit System, Farm Credit Leasing Services Corporation, and their successors, and any other institution chartered by the FCA that the FCA determines should be considered a System institution for the purposes of this part. *Synthetic exposure* means an exposure whose value is linked to the value of an investment in the System institution's own capital instrument.

Synthetic securitization means a transaction in which:

(1) All or a portion of the credit risk of one or more underlying exposures is retained or transferred to one or more third parties through the use of one or more credit derivatives or guarantees (other than a guarantee that transfers only the credit risk of an individual retail exposure);

(2) The credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority;

(3) Performance of the securitization exposures depends upon the performance of the underlying exposures; and

(4) 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).

Tier 1 capital means the sum of common equity tier 1 capital and additional tier 1 capital.

Tier 2 capital is defined in § 628.20(d).

Total capital means the sum of tier 1 capital and tier 2 capital.

Traditional securitization means a transaction in which:

(1) All or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties other than through the use of credit derivatives or guarantees;

(2) The credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority;

(3) Performance of the securitization exposures depends upon the performance of the underlying exposures;

(4) 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);

(5) The underlying exposures are not owned by an operating entity;

(6) The underlying exposures are not owned by a rural business investment company described in 7 U.S.C. 2009cc *et seq.*;

(7) The underlying exposures are not owned by a firm an investment in which is authorized by the FCA under § 615.5140(e) of this chapter;

(8) The FCA may determine that a transaction in which the underlying exposures are owned by an investment firm that exercises substantially unfettered control over the size and composition of its assets, liabilities, and off-balance sheet exposures is not a traditional securitization based on the transaction's leverage, risk profile, or economic substance;

(9) The FCA may deem a transaction that meets the definition of a traditional securitization, notwithstanding paragraph (5), (6), or (7) of this definition, to be a traditional securitization based on the transaction's leverage, risk profile, or economic substance; and

(10) The transaction is not:

(i) An investment fund;

(ii) A collective investment fund (as defined in [12 CFR 9.18 (national bank) and 12 CFR 151.40 (Federal saving association) (OCC); 12 CFR 208.34 (Board)]);

(iii) An employee benefit plan (as defined in paragraphs (3) and (32) of section 3 of ERISA), a "governmental plan" (as defined in 29 U.S.C. 1002(32)) that complies with the tax deferral qualification requirements provided in the Internal Revenue Code, or any similar employee benefit plan established under the laws of a foreign jurisdiction;

(iv) A synthetic exposure to the capital of a System institution to the extent deducted from capital under § 628.22; or

(v) Registered with the SEC under the Investment Company Act of 1940 (15 U.S.C. 80a-1) or foreign equivalents thereof.

Tranche means all securitization exposures associated with a securitization that have the same seniority level.

Two-way market means a market where there are independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined within 1 day and settled at that price within a relatively short timeframe conforming to trade custom.

Unallocated retained earnings (URE) means accumulated net income that a System institution has not allocated as patronage refunds.

Unallocated retained earnings (URE) equivalents means nonqualified allocated surplus not subject to retirement except upon dissolution or liquidation. URE equivalents does not include equities allocated by a System institution to other System institutions.

Unconditionally cancelable means, with respect to a commitment that a System institution may, at any time, with or without cause, refuse to extend credit under the commitment (to the extent permitted under applicable law).

Underlying exposures means one or more exposures that have been securitized in a securitization transaction.

U.S. Government agency means an instrumentality of the U.S. Government whose obligations are fully guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. Government.

§ 628.3 Operational requirements for certain exposures.

For purposes of calculating risk-weighted assets under subpart D of this part:

(a) *Cleared transaction*. In order to recognize certain exposures as cleared transactions pursuant to paragraph (1)(ii), (1)(iii) or (1)(iv) of the definition of "cleared transaction" in § 628.2, the exposures must meet all of the requirements set forth in this paragraph.

(1) The offsetting transaction must be identified by the CCP as a transaction for the clearing member client.

(2) The collateral supporting the transaction must be held in a manner that prevents the System institution from facing any loss due to an event of default, including from a liquidation, receivership, insolvency, or similar proceeding of either the clearing member or the clearing member's other clients. Omnibus accounts established under 17 CFR parts 190 and 300 satisfy the requirements of this paragraph.

(3) The System institution must conduct sufficient legal review to

conclude with a well-founded basis (and maintain sufficient written documentation of that legal review) that in the event of a legal challenge (including one resulting from a default or receivership, insolvency, liquidation, or similar proceeding) the relevant court and administrative authorities would find the arrangements of paragraph (a)(2) of this section to be legal, valid, binding and enforceable under the law of the relevant jurisdictions.

(4) The offsetting transaction with a clearing member must be transferable under the transaction documents and applicable laws in the relevant jurisdiction(s) to another clearing member should the clearing member default, become insolvent, or enter receivership, insolvency, liquidation, or similar proceedings.

(b) *Eligible margin loan.* In order to recognize an exposure as an eligible margin loan as defined in § 628.2, a System institution must conduct sufficient legal review to conclude with a well-founded basis (and maintain sufficient written documentation of that legal review) that the agreement underlying the exposure:

(1) Meets the requirements of paragraph (1)(iii) of the definition of “eligible margin loan” in § 628.2, and

(2) Is legal, valid, binding, and enforceable under applicable law in the relevant jurisdictions.

(c) [Reserved]

(d) *Qualifying master netting agreement.* In order to recognize an agreement as a qualifying master netting agreement as defined in § 628.2, a System institution must:

(1) Conduct sufficient legal review to conclude with a well-founded basis (and maintain sufficient written documentation of that legal review) that:

(i) The agreement meets the requirements of paragraph (2) of the definition of “qualifying master netting agreement” in § 628.2; and

(ii) In the event of a legal challenge (including one resulting from default or from receivership, insolvency, liquidation, or similar proceeding) the relevant court and administrative authorities would find the agreement to be legal, valid, binding, and enforceable under the law of the relevant jurisdictions; and

(2) Establish and maintain written procedures to monitor possible changes in relevant law and to ensure that the agreement continues to satisfy the requirements of the definition of “qualifying master netting agreement” in § 628.2.

(e) *Repo-style transaction.* In order to recognize an exposure as a repo-style transaction as defined in § 628.2, a

System institution must conduct sufficient legal review to conclude with a well-founded basis (and maintain sufficient written documentation of that legal review) that the agreement underlying the exposure:

(1) Meets the requirements of paragraph (3) of the definition of “repo-style transaction” in § 628.2, and

(2) Is legal, valid, binding, and enforceable under applicable law in the relevant jurisdictions.

(f) *Failure of a QCCP to satisfy the rule’s requirements.* If a System institution determines that a CCP ceases to be a QCCP due to the failure of the CCP to satisfy one or more of the requirements set forth in paragraph (2)(i) through (2)(iii) of the definition of a “QCCP” in § 628.2, the System institution may continue to treat the CCP as a QCCP for up to 3 months following the determination. If the CCP fails to remedy the relevant deficiency within 3 months after the initial determination, or the CCP fails to satisfy the requirements set forth in paragraph (2)(i) through (2)(iii) of the definition of a QCCP continuously for a 3-month period after remedying the relevant deficiency, a System institution may not treat the CCP as a QCCP for the purposes of this part until after the System institution has determined that the CCP has satisfied the requirements in paragraph (2)(i) through (2)(iii) of the definition of a QCCP for 3 continuous months.

§§ 628.4—628.9 [Reserved]

Subpart B—Capital Ratio Requirements and Buffers

§ 628.10 Minimum capital requirements.

(a) *Computation of regulatory capital ratios.* A System institution’s regulatory capital ratios are determined on the basis of the financial statements of the institution prepared in accordance with GAAP using average daily balances for the most recent 3 months.

(b) *Minimum capital requirements.* A System institution must maintain the following minimum capital ratios:

(1) A common equity tier 1 (CET1) capital ratio of 4.5 percent.

(2) A tier 1 capital ratio of 6 percent.

(3) A total capital ratio of 8 percent.

(4) A tier 1 leverage ratio of 5 percent, of which at least 1.5 percent must be composed of URE and URE equivalents.

(5) [Reserved]

(6) A permanent capital ratio of 7 percent.

(c) *Capital ratio calculations.* A System institution’s regulatory capital ratios are as follows:

(1) *CET1 capital ratio.* A System institution’s CET1 capital ratio is the

ratio of the System institution’s CET1 capital to total risk-weighted assets;

(2) *Tier 1 capital ratio.* A System institution’s tier 1 capital ratio is the ratio of the System institution’s tier 1 capital to total risk-weighted assets;

(3) *Total capital ratio.* A System institution’s total capital ratio is the ratio of the System institution’s total (tier 1 and tier 2) capital to total risk-weighted assets; and

(4) *Tier 1 leverage ratio.* A System institution’s leverage ratio is the ratio of the institution’s tier 1 capital to the institution’s average total consolidated assets as reported on the institution’s Call Report minus amounts deducted from tier 1 capital under §§ 628.22(a), (c) and (d), and 628.23.

(5) *Permanent capital ratio.* A System institution’s permanent capital ratio must be calculated in accordance with the regulations in part 615, subpart H, of this chapter.

(d) [Reserved]

(e) *Capital adequacy.* (1)

Notwithstanding the minimum requirements in this part, a System institution must maintain capital commensurate with the level and nature of all risks to which the System institution is exposed. FCA may evaluate a System institution’s capital adequacy and require that institution to maintain higher minimum regulatory capital ratios using the factors listed in § 615.5350 of this chapter.

(2) A System institution must have a process for assessing its overall capital adequacy in relation to its risk profile and a comprehensive strategy for maintaining an appropriate level of capital under § 615.5200 of this chapter.

§ 628.11 Capital conservation buffer amount.

(a) *Capital conservation buffer—(1) Composition of the capital conservation buffer.* The capital conservation buffer is composed solely of CET1 capital.

(2) *Definitions.* For purposes of this section, the following definitions apply:

(i) *Eligible retained income.* The eligible retained income of a System institution is the System institution’s net income for the 4 calendar quarters preceding the current calendar quarter, based on the System institution’s quarterly Call Reports, net of any capital distributions and associated tax effects not already reflected in net income.

(ii) *Maximum payout ratio.* The maximum payout ratio is the percentage of eligible retained income that a System institution can pay out in the form of capital distributions and discretionary bonus payments during the current calendar quarter. The maximum payout ratio is based on the

System institution's capital conservation buffer, calculated as of the last day of the previous calendar quarter, as set forth in Table 1 to § 628.11.

(iii) *Maximum payout amount.* A System institution's maximum payout amount for the current calendar quarter is equal to the System institution's eligible retained income, multiplied by the applicable maximum payout ratio, as set forth in Table 1 to § 628.11.

(iv) [Reserved]

(v) *Capital distribution means:*

(A) A reduction of tier 1 capital through the repurchase or redemption of a tier 1 capital instrument or by other means, except when a System institution, within the same quarter when the repurchase is announced, fully replaces a tier 1 capital instrument it has repurchased by issuing another capital instrument that meets the eligibility criteria for:

(1) A CET1 capital instrument if the instrument being repurchased was part of the System institution's CET1 capital; or

(2) A CET1 or AT1 capital instrument if the instrument being repurchased was part of the System institution's tier 1 capital;

(B) A reduction of tier 2 capital through the repurchase, or redemption prior to maturity, of a tier 2 capital instrument or by other means, except when a System institution, within the same quarter when the repurchase or redemption is announced, fully replaces a tier 2 capital instrument it has repurchased by issuing another capital instrument that meets the eligibility criteria for a tier 1 or tier 2 capital instrument;

(C) A dividend declaration or payment on any tier 1 capital instrument;

(D) A dividend declaration or interest payment on any tier 2 capital instrument if the System institution has full discretion to permanently or temporarily suspend such payments without triggering an event of default;

(E) A cash patronage refund declaration or payment;

(F) A patronage refund declaration in the form of allocated equities that did not qualify as tier 1 or tier 2 capital;⁵ or

(G) Any similar transaction that the FCA determines to be in substance a distribution of capital.

(3) *Calculation of capital conservation buffer.* (i) A System institution's capital conservation buffer is equal to the

lowest of the following ratios, calculated as of the last day of the previous calendar quarter based on the System institution's most recent Call Report:

(A) The System institution's CET1 capital ratio minus the System institution's minimum CET1 capital ratio requirement under § 628.10;

(B) The System institution's tier 1 capital ratio minus the System institution's minimum tier 1 capital ratio requirement under § 628.10; and

(C) The System institution's total capital ratio minus the System institution's minimum total capital ratio requirement under § 628.10; or

(ii) Notwithstanding paragraphs (a)(3)(i)(A) through (C) of this section, if the System institution's CET1, tier 1 or total capital ratio is less than or equal to the System institution's minimum CET1, tier 1 or total capital ratio requirement under § 628.10, respectively, the System institution's capital conservation buffer is zero.

(4) *Limits on capital distributions and discretionary bonus payments.* (i) A System institution must not make capital distributions or discretionary bonus payments or create an obligation to make such capital distributions or payments during the current calendar quarter that, in the aggregate, exceed the maximum payout amount.

(ii) A System institution with a capital conservation buffer that is greater than 2.5 percent is not subject to a maximum payout amount under this section.

(iii) *Negative eligible retained income.* Except as provided in paragraph (a)(4)(iv) of this section, a System institution may not make capital distributions or discretionary bonus payments during the current calendar quarter if the System institution's:

(A) Eligible retained income is negative; and

(B) Capital conservation buffer was less than 2.5 percent as of the end of the previous calendar quarter.

(iv) *Prior approval.* Notwithstanding the limitations in paragraphs (a)(4)(i) through (a)(4)(iii) of this section, FCA may permit a System institution to make a capital distribution or discretionary bonus payment upon a request of the System institution, if FCA determines that the capital distribution or discretionary bonus payment would not be contrary to the purposes of this section, or to the safety and soundness of the System institution. In making such a determination, FCA will consider the nature and extent of the request and the particular circumstances giving rise to the request.

TABLE 1 TO § 628.11—CALCULATION OF MAXIMUM PAYOUT AMOUNT

Capital conservation buffer	Maximum payout ratio (as a percentage of eligible retained income)
> 2.500 percent	No limitation
≤ 2.500 percent, and > 1.875 percent	60
≤ 1.875 percent, and > 1.250 percent	40
≤ 1.250 percent, and > 0.625 percent	20
≤ 0.625 percent	0

(v) *Other limitations on capital distributions.* Additional limitations on capital distributions may apply to a System institution under subpart C of this part and under part 615, subparts L and M.

(b) [Reserved]

§§ 628.12—628.19 [Reserved]

Subpart C—Definition of Capital

§ 628.20 Capital components and eligibility criteria for regulatory capital instruments other than permanent capital.

(a) *Regulatory capital components.* A System institution's regulatory capital components are:

- (1) CET1 capital;
- (2) AT1 capital; and
- (3) Tier 2 capital.

(b) *CET1 capital.* CET1 capital is the sum of the CET1 capital elements in paragraph (b) of this section, minus regulatory adjustments and deductions in § 628.22. The CET1 capital elements are:

(1) Any common cooperative equity instrument issued by a System institution that meets all of the following criteria:

(i) The instrument is issued directly by the System institution and represents a claim subordinated to general creditors, subordinated debt holders, and preferred stock holders in a receivership, insolvency, liquidation, or similar proceeding of the System institution;

(ii) The holder of the instrument is entitled to a claim on the residual assets of the System institution, the claim will be paid only after all creditors, subordinated debt holders, and preferred stock claims have been satisfied in a receivership, insolvency, liquidation, or similar proceeding;

(iii) The instrument has no maturity date, can be redeemed only at the discretion of the System institution and with the prior approval of FCA, and

⁵ A patronage refund declaration or payment in the form of allocated equities that qualifies as tier 1 capital is not a reduction in tier 1 capital. It is just a reclassification from one tier 1 capital element into a different tier 1 capital element.

does not contain any term or feature that creates an incentive to redeem;

(iv) The System institution did not create, through any action or communication, an expectation that it will buy back, cancel, revolve, or redeem the instrument, and the instrument does not include any term or feature that might give rise to such an expectation, except that the establishment of a revolving period of 10 years or more, or the practice of revolving or redeeming the instrument no less than 10 years after issuance or allocation, will not be considered to create such an expectation;

(v) Any cash dividend payments on the instrument are paid out of the System institution's net income or unallocated retained earnings, and are not subject to a limit imposed by the contractual terms governing the instrument;

(vi) The System institution has full discretion at all times to refrain from paying any dividends without triggering an event of default, a requirement to make a payment-in-kind, or an imposition of any other restrictions on the System institution;

(vii) Dividend payments and other distributions related to the instrument may be paid only after all legal and contractual obligations of the System institution have been satisfied, including payments due on more senior claims;

(viii) The holders of the instrument bear losses as they occur before any losses are borne by holders of preferred stock claims on the System institution and holders of any other claims with priority over common cooperative equity instruments in a receivership, insolvency, liquidation, or similar proceeding;

(ix) The instrument is classified as equity under GAAP;

(x) The System institution, or an entity that the System institution controls, did not purchase or directly or indirectly fund the purchase of the instrument, except that where there is an obligation for a member of the institution to hold an instrument in order to receive a loan or service from the System institution, an amount of that loan equal to the minimum borrower stock requirement under section 4.3A of the Act will not be considered as a direct or indirect funding where:

(A) The purpose of the loan is not the purchase of capital instruments of the System institution providing the loan; and

(B) The purchase or acquisition of one or more member equities of the institution is necessary in order for the

beneficiary of the loan to become a member of the System institution;

(xi) The instrument is not secured, not covered by a guarantee of the System institution, and is not subject to any other arrangement that legally or economically enhances the seniority of the instrument;

(xii) The instrument is issued in accordance with applicable laws and regulations and with the institution's capitalization bylaws;

(xiii) The instrument is reported on the System institution's regulatory financial statements separately from other capital instruments; and

(xiv) The System institution's capitalization bylaws provide that it will not offset the instrument against a member's loan in default, that it will not redeem the instrument for a period of at least 10 years after issuance, or if allocated equities at least 10 years after allocation to a member, or reduce the original revolving period to less than 10 years without the prior approval of the FCA, except that the minimum statutory borrower stock described under paragraph (b)(1)(x) of this section may be redeemed without a minimum period outstanding after issuance and without the prior approval of the FCA.

(2) Unallocated retained earnings.

(3) [Reserved]

(4) [Reserved]

(5) [Reserved]

(c) *AT1 capital*. AT1 capital is the sum of additional tier 1 capital elements and related surplus, minus the regulatory adjustments and deductions in §§ 628.22 and 628.23. AT1 capital elements are:

(1) Instruments and related surplus, other than common cooperative equities, that meet the following criteria:

(i) The instrument is issued and paid-in;

(ii) The instrument is subordinated to general creditors and subordinated debt holders of the System institution in a receivership, insolvency, liquidation, or similar proceeding;

(iii) The instrument is not secured, not covered by a guarantee of the System institution and not subject to any other arrangement that legally or economically enhances the seniority of the instrument;

(iv) The instrument has no maturity date and does not contain a dividend step-up or any other term or feature that creates an incentive to redeem;

(v) If callable by its terms, the instrument may be called by the System institution only after a minimum of 5 years following issuance, except that the terms of the instrument may allow it to be called earlier than 5 years upon the occurrence of a regulatory event that

precludes the instrument from being included in AT1 capital, or a tax event.

In addition:

(A) The System institution must receive prior approval from FCA to exercise a call option on the instrument.

(B) The System institution does not create at issuance of the instrument, through any action or communication, an expectation that the call option will be exercised.

(C) Prior to exercising the call option, or immediately thereafter, the System institution must either replace the instrument to be called with an equal amount of instruments that meet the criteria under paragraph (b) of this section or this paragraph (c),⁶ or demonstrate to the satisfaction of FCA that following redemption, the System institution will continue to hold capital commensurate with its risk;

(vi) Redemption or repurchase of the instrument requires prior approval from FCA;

(vii) The System institution has full discretion at all times to cancel dividends or other distributions on the instrument without triggering an event of default, a requirement to make a payment-in-kind, or an imposition of other restrictions on the System institution except in relation to any distributions to holders of common cooperative equity instruments or other instruments that are *pari passu* with the instrument;

(viii) Any distributions on the instrument are paid out of the System institution's net income, unallocated retained earnings, or surplus related to other AT1 capital instruments and are not subject to a limit imposed by the contractual terms governing the instrument;

(ix) The instrument does not have a credit-sensitive feature, such as a dividend rate that is reset periodically based in whole or in part on the System institution's credit quality, but may have a dividend rate that is adjusted periodically independent of the System institution's credit quality, in relation to general market interest rates or similar adjustments;

(x) The paid-in amount is classified as equity under GAAP;

(xi) The System institution did not purchase or directly or indirectly fund the purchase of the instrument;

(xii) The instrument does not have any features that would limit or discourage additional issuance of capital by the System institution, such as provisions that require the System institution to compensate holders of the

⁶ Replacement can be concurrent with redemption of existing AT1 capital instruments.

instrument if a new instrument is issued at a lower price during a specified timeframe;

(xiii) [Reserved]; and

(xiv) The System institution's capitalization bylaws provide that it will not redeem the instrument without the prior approval of the FCA;

(2) [Reserved];

(3) [Reserved];

(4) Notwithstanding the criteria for AT1 capital instruments referenced above:

(i) [Reserved];

(ii) An instrument with terms that provide that the instrument may be called earlier than 5 years upon the occurrence of a rating agency event does not violate the criterion in paragraph (c)(1)(v) of this section provided that the instrument was issued and included in a System institution's core surplus capital prior to the effective date of the final rule, and that such instrument satisfies all other criteria under this § 628.20(c).

(d) *Tier 2 Capital*. Tier 2 capital is the sum of tier 2 capital elements and any related surplus minus regulatory adjustments and deductions in §§ 628.22 and 628.23. Tier 2 capital elements are:

(1) Instruments (plus related surplus) that meet the following criteria:

(i) The instrument is issued and paid-in, is a common cooperative equity, or is member equity purchased in accordance with paragraph (d)(1)(viii) of this section;

(ii) The instrument is subordinated to general creditors of the System institution;

(iii) The instrument is not secured, not covered by a guarantee of the System institution and not subject to any other arrangement that legally or economically enhances the seniority of the instrument in relation to more senior claims;

(iv) The instrument has a minimum original maturity of at least 5 years. At the beginning of each of the last 5 years of the life of the instrument, the amount that is eligible to be included in tier 2 capital is reduced by 20 percent of the original amount of the instrument (net of redemptions) and is excluded from regulatory capital when the remaining maturity is less than 1 year. In addition, the instrument must not have any terms or features that require, or create significant incentives for, the System institution to redeem the instrument prior to maturity;⁷

(v) The instrument, by its terms, may be called by the System institution only after a minimum of 5 years following issuance, except that the terms of the instrument may allow it to be called sooner upon the occurrence of an event that would preclude the instrument from being included in tier 2 capital, or a tax event. In addition:

(A) The System institution must receive the prior approval of FCA to exercise a call option on the instrument.

(B) The System institution does not create at issuance, through action or communication, an expectation the call option will be exercised.

(C) Prior to exercising the call option, or immediately thereafter, the System institution must either: replace any amount called with an equivalent amount of an instrument that meets the criteria for regulatory capital under this section;⁸ or demonstrate to the satisfaction of FCA that following redemption, the System institution would continue to hold an amount of capital that is commensurate with its risk;

(vi) The holder of the instrument must have no contractual right to accelerate payment of principal, dividends, or interest on the instrument, except in the event of a receivership, insolvency, liquidation, or similar proceeding of the System institution;

(vii) The instrument has no credit-sensitive feature, such as a dividend or interest rate that is reset periodically based in whole or in part on the System institution's credit standing, but may have a dividend rate that is adjusted periodically independent of the System institution's credit standing, in relation to general market interest rates or similar adjustments;

(viii) The System institution has not purchased and has not directly or indirectly funded the purchase of the instrument, except that where common cooperative equity instruments are held by a member of the institution in connection with a loan, and the institution funds the acquisition of such instruments, that loan shall not be considered as a direct or indirect funding where:

(A) The purpose of the loan is not the purchase of capital instruments of the System institution providing the loan;

(B) The purchase or acquisition of one or more capital instruments of the institution is necessary in order for the beneficiary of the loan to become a member of the System institution; and

(C) The capital instruments are in excess of the statutory minimum stock purchase amount.

(ix) [Reserved]

(x) Redemption of the instrument prior to maturity or repurchase is at the discretion of the System institution and requires the prior approval of the FCA;

(xi) If the instrument is a common cooperative equity, the System institution's capitalization bylaws provide that it will not, except with the prior approval of the FCA, redeem such equity included in tier 2 capital for a period of at least 5 years after allocating it to a member.

(2) [Reserved]

(3) ALL up to 1.25 percent of the System institution's total risk-weighted assets not including any amount of the ALL.

(4) [Reserved]

(5) [Reserved]

(6) [Reserved]

(e) *FCA approval of a capital element*.

(1) A System institution must receive FCA prior approval to include a capital element (as listed in this section) in its CET1 capital, AT1 capital, or tier 2 capital unless the element is equivalent, in terms of capital quality and ability to absorb losses with respect to all material terms, to a regulatory capital element FCA determined may be included in regulatory capital pursuant to paragraph (e)(3) of this section.

(i) [Reserved]

(ii) [Reserved]

(2) [Reserved]

(3) After determining that a regulatory capital element may be included in a System institution's CET1 capital, AT1 capital, or tier 2 capital, FCA will make its decision publicly available.

(f) *FCA prior approval of capital redemptions and dividends included in tier 1 and tier 2 capital*. (1) Subject to the provisions of paragraph (f)(5) of this section, a System institution must obtain the prior approval of the FCA before paying cash dividends or patronage refunds or redeeming equities included in tier 1 or tier 2 capital, other than term equities redeemed on their maturity date.

(2) At least 30 days prior to the intended action, the System institution must submit a request for approval to the FCA. The FCA's 30-day review period begins on the date on which the FCA receives the request.

(3) The request is deemed to be granted if the FCA does not notify the System institution to the contrary before the end of the 30-day review period.

(4)(i) A System institution may request advance approval to cover several anticipated redemptions and dividend and patronage payments,

⁷ An instrument that by its terms automatically converts into a tier 1 capital instrument prior to 5 years after issuance complies with the 5-year maturity requirement of this criterion.

⁸ A System institution may replace tier 2 capital instruments concurrent with the redemption of existing tier 2 capital instruments.

provided that the institution projects sufficient current net income during those periods to support the amount of the dividends declared, patronage refunds and redemptions. In determining whether to grant advance approval, the FCA will consider:

- (A) The reasonableness of the institution's request, including its historical and projected patronage refunds, redemptions and dividend payments;
- (B) The institution's historical trends and current projections for capital growth through earnings retention;
- (C) The overall condition of the institution, with particular emphasis on current and projected capital adequacy as described in § 628.10(e); and
- (D) Any other information that the FCA deems pertinent to reviewing the institution's request.

(ii) After considering these standards, the FCA may grant prior approval for an institution's patronage refunds, redemptions and dividends request in advance of the periods in which the patronage refunds, redemptions and dividends will be declared. Notwithstanding any such approval, an institution may not declare or pay a patronage refund, redeem equities or declare or pay a dividend if, after making the patronage refunds, redemptions or dividend payments, the institution would not meet its regulatory capital requirements set forth in parts 615 and 628.

(5) Subject to any capital distribution restrictions specified in § 628.11, a System institution is deemed to have FCA prior approval for cash payments of dividends, patronage refunds, or revolvments and redemptions of common cooperative equities provided that:

- (i) For revolvments or redemptions of common cooperative equities included in CET1 capital other than a member's statutory minimum borrower stock purchase requirement described in § 628.20(b)(1)(x), the institution issued or allocated such equities at least 10 years ago;
- (ii) For revolvments or redemptions of common cooperative equities included in Tier 2 capital, the institution issued or allocated such equities at least 5 years ago;
- (iii) After such cash distributions the dollar amount of the System institution's CET1 capital equals or exceeds the dollar amount of CET1 capital on the same date in the previous calendar year; and

(B) The System institution continues to comply with all regulatory capital requirements and supervisory or enforcement actions.

§ 628.21 [Reserved]

§ 628.22 Regulatory capital adjustments and deductions.

(a) *Regulatory capital deductions from CET1 capital.* A System institution must deduct from the sum of its CET1 capital elements the items set forth in this paragraph:

- (1) Goodwill, net of associated deferred tax liabilities (DTLs) in accordance with paragraph (e) of this section;
- (2) Intangible assets, other than mortgage servicing assets (MSAs), net of associated DTLs in accordance with paragraph (e) of this section;
- (3) Deferred tax assets (DTAs) that arise from net operating loss and tax credit carryforwards net of any related valuation allowances and net of DTLs in accordance with paragraph (e) of this section;⁹
- (4) Any gain-on-sale in connection with a securitization exposure;
- (5) Any defined benefit pension fund net asset, net of any associated DTL in accordance with paragraph (e) of this section;
- (6) The System institution's allocated equity investment in another System institution;
- (7) [Reserved]; and
- (8) If, without the required prior FCA approval, during the 12 previous quarters, the System institution redeemed or revolved allocated equities included in its CET1 capital that it had allocated during the previous 10 years or retired purchased stock that it had issued in the previous 10 years, the institution must deduct 30 percent of its purchased and allocated equities for 3 years otherwise includable in CET1 capital. However, no deduction will be made of allocated equities that are URE equivalents unless the institution redeemed or revolved URE equivalents.

(b) [Reserved]

(c) *Deductions from regulatory capital.*¹⁰

- (1) [Reserved]
- (2) *Corresponding deduction approach.* For purposes of subpart C of this part, the corresponding deduction approach is the methodology used for the deductions from regulatory capital related to purchased equity investments in another System institution (as described in paragraph (c)(5) of this section). Under the corresponding deduction approach, a System

⁹ See § 628.30(a) for DTAs arising from temporary differences that a System institution could not realize through net operating loss carrybacks.

¹⁰ The System institution must calculate amounts deducted under §§ 628.22(c) through (f) and 628.23 after it calculates the amount of ALL includable in tier 2 capital under § 628.20(d)(3).

institution must make deductions from the component of capital for which the underlying instrument would qualify if it were issued by the System institution itself. If the System institution does not have a sufficient amount of a specific component of capital to effect the required deduction, the shortfall must be deducted according to paragraph (f) of this section.

- (i) [Reserved]
- (ii) [Reserved]
- (iii) [Reserved]
- (3) [Reserved]
- (4) [Reserved]

(5) *Purchased equity investments in another System institution.* System institutions must deduct all purchased equity investments in another System institution, service corporation, or the Funding Corporation by applying the corresponding deduction approach.¹¹ The deductions described in this section are net of associated DTLs in accordance with paragraph (e) of this section.

(d) [Reserved]

(e) *Netting of DTLs against assets subject to deduction.* (1) The netting of DTLs against assets that are subject to deduction under § 628.22 is required, if the following conditions are met:

- (i) The DTL is associated with the asset; and
- (ii) The DTL would be extinguished if the associated asset becomes impaired or is derecognized under GAAP.

(2) A DTL may only be netted against a single asset.

- (3) [Reserved]
- (4) [Reserved]
- (5) [Reserved]

(f) *Insufficient amounts of a specific regulatory capital component to effect deductions.* Under the corresponding deduction approach, if a System institution does not have a sufficient amount of a specific component of capital to effect the required deduction after completing the deductions required under § 628.22(c), the System institution must deduct the shortfall from the next higher (that is, more subordinated) component of regulatory capital.

(g) *Treatment of assets that are deducted.* A System institution must exclude from total risk-weighted assets any item deducted from regulatory capital under paragraphs (a) and (c) of this section.

(h) [Reserved]

¹¹ With prior written approval of FCA, for the period stipulated by FCA, a System institution is not required to deduct an investment in the capital of another institution in distress if such investment is made to provide financial support to the System institution as determined by FCA.

§ 628.23 Limits on third-party capital.

(a) *Limit on inclusion of third-party capital in tier 1 capital.* The combined amount of third-party capital instruments that a System institution may include in tier 1 capital is equal to the greater of the following:

- (1) The then existing limit, if any, or
- (2) One third of the average of the previous 4 quarters for the previous year of the tier 1 capital reported on its Call Report filed with FCA less any amounts of third-party capital reported in tier 1 capital.

(b) *Limit on inclusion of third-party capital in total (tier 1 and tier 2) capital.* The combined amount of third-party capital instruments that a System institution may include in its total (tier 1 and tier 2) capital is equal to the lesser of the following:

- (1) An amount equal to 40 percent of its total capital outstanding, or
- (2) An amount equal to 100 percent of its tier 1 capital outstanding.

(c) *Treatment of assets that are deducted.* A System institution must exclude from total risk-weighted assets any item deducted from regulatory capital under this section.

§§ 628.24–628.29 [Reserved]

Subpart D—Risk-Weighted Assets—Standardized Approach

§ 628.30 Applicability.

(a) This subpart sets forth methodologies for determining risk-weighted assets for purposes of the generally applicable risk-based capital requirements for all System institutions.

(b) [Reserved]

Risk-Weighted Assets for General Credit Risk

§ 628.31 Mechanics for calculating risk-weighted assets for general credit risk.

(a) *General risk-weighting requirements.* A System institution must apply risk weights to its exposures as follows:

(1) A System institution must determine the exposure amount of each on-balance sheet exposure, each OTC derivative contract, and each off-balance sheet commitment, trade and transaction-related contingency, guarantee, repo-style transaction, financial standby letter of credit, forward agreement, or other similar transaction that is not:

- (i) An unsettled transaction subject to § 628.38;
- (ii) A cleared transaction subject to § 628.35;
- (iii) [Reserved];
- (iv) A securitization exposure subject to §§ 628.41 through 628.45; or

(v) An equity exposure (other than an equity OTC derivative contract) subject to §§ 628.51 through 628.53.

(2) The System institution must multiply each exposure amount by the risk weight appropriate to the exposure based on the exposure type or counterparty, eligible guarantor, or financial collateral to determine the risk-weighted asset amount for each exposure.

(b) Total risk-weighted assets for general credit risk equals the sum of the risk-weighted asset amounts calculated under this section.

§ 628.32 General risk weights.

(a) *Sovereign exposures—(1) Exposures to the U.S. Government.* (i) Notwithstanding any other requirement in this subpart, a System institution must assign a 0-percent risk weight to:

(A) An exposure to the U.S. Government, its central bank, or a U.S. Government agency; and

(B) The portion of an exposure that is directly and unconditionally guaranteed by the U.S. Government, its central bank, or a U.S. Government agency. This includes a deposit or other exposure, or the portion of a deposit or other exposure, that is insured or otherwise unconditionally guaranteed by the Federal Deposit Insurance Corporation or National Credit Union Administration.

(ii) A System institution must assign a 20-percent risk weight to the portion of an exposure that is conditionally guaranteed by the U.S. Government, its central bank, or a U.S. Government agency. This includes an exposure, or the portion of an exposure, that is conditionally guaranteed by the Federal Deposit Insurance Corporation or National Credit Union Administration.

(2) *Other sovereign exposures.* In accordance with Table 1 to § 628.32, a System institution must assign a risk weight to a sovereign exposure based on the Country Risk Classification (CRC) applicable to the sovereign or the sovereign's Organization for Economic Cooperation and Development (OECD) membership status if there is no CRC applicable to the sovereign.

TABLE 1 TO § 628.32—RISK WEIGHTS FOR SOVEREIGN EXPOSURES

	Risk weight (in percent)
CRC:	
0–1	0
2	20
3	50
4–6	100
7	150
OECD Member with no CRC	0

TABLE 1 TO § 628.32—RISK WEIGHTS FOR SOVEREIGN EXPOSURES—Continued

	Risk weight (in percent)
Non-OECD Member with no CRC	100
Sovereign Default	150

(3) *Certain sovereign exposures.* Notwithstanding paragraph (a)(2) of this section, a System institution may assign to a sovereign exposure a risk weight that is lower than the applicable risk weight in Table 1 to § 628.32 if:

- (i) The exposure is denominated in the sovereign's currency;
- (ii) The System institution has at least an equivalent amount of liabilities in that currency; and
- (iii) The risk weight is not lower than the risk weight that the sovereign allows banking organizations under its jurisdiction to assign to the same exposures to the sovereign.

(4) *Exposures to a non-OECD member sovereign with no CRC.* Except as provided in paragraph (a)(3), (a)(5), and (a)(6) of this section, a System institution must assign a 100-percent risk weight to a sovereign exposure if the sovereign does not have a CRC.

(5) *Exposures to an OECD member sovereign with no CRC.* Except as provided in paragraph (a)(6) of this section, a System institution must assign a 0-percent risk weight to an exposure to a sovereign that is a member of the OECD if the sovereign does not have a CRC.

(6) *Sovereign default.* A System institution must assign a 150-percent risk weight to a sovereign exposure immediately upon determining that an event of sovereign default has occurred, or if an event of sovereign default has occurred during the previous 5 years.

(b) *Certain supranational entities and multilateral development banks (MDBs).* A System institution must assign a 0-percent risk weight to an exposure to the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, or an MDB.

(c) *Exposures to Government-sponsored enterprises (GSEs).* (1) A System institution must assign a 20-percent risk weight to an exposure to a GSE other than an equity exposure or preferred stock.

(2) A System institution must assign a 100-percent risk weight to preferred stock issued by a GSE.

(d) *Exposures to depository institutions, foreign banks, and credit unions—(1) Exposures to U.S.*

depository institutions and credit unions. A System institution must assign a 20-percent risk weight to an exposure to a depository institution or credit union that is organized under the laws of the United States or any state thereof, except as otherwise provided in this paragraph. This risk weight applies to an exposure a System bank has to an other financing institution (OFI) that is a depository institution or credit union organized under the laws of the United States or any state thereof or owned and controlled by such an entity that guarantees the exposure. If the OFI exposure does not satisfy these requirements, it must be assigned a risk weight as a corporate exposure pursuant to paragraph (f)(2) of this section.

(2) *Exposures to foreign banks.* (i) Except as otherwise provided under paragraphs (d)(2)(iv) of this section, a System institution must assign a risk weight to an exposure to a foreign bank, in accordance with Table 2 to § 628.32, based on the CRC rating that corresponds to the foreign bank's home country or the OECD membership status of the foreign bank's home country if there is no CRC applicable to the foreign bank's home country.

TABLE 2 TO § 628.32—RISK WEIGHTS FOR EXPOSURES TO FOREIGN BANKS

	Risk weight (in percent)
CRC:	
0–1	20
2	50
3	100
4–7	150
OECD Member with No CRC	20
Non-OECD with No CRC	100
Sovereign Default	150

(ii) A System institution must assign a 20-percent risk weight to an exposure to a foreign bank whose home country is a member of the OECD and does not have a CRC.

(iii) A System institution must assign a 100-percent risk weight to an exposure to a foreign bank whose home country is not a member of the OECD and does not have a CRC, with the exception of self-liquidating, trade-related contingent items that arise from the movement of goods, and that have a maturity of 3 months or less, which may be assigned a 20-percent risk weight.

(iv) A System institution must assign a 150-percent risk weight to an exposure to a foreign bank immediately upon determining that an event of sovereign default has occurred in the bank's home country, or if an event of sovereign default has occurred in the foreign

bank's home country during the previous 5 years.

(3) [Reserved]

(e) *Exposures to public sector entities (PSEs).*—(1) *Exposures to U.S. PSEs.* (i) A System institution must assign a 20-percent risk weight to a general obligation exposure to a PSE that is organized under the laws of the United States or any state or political subdivision thereof.

(ii) A System institution must assign a 50-percent risk weight to a revenue obligation exposure to a PSE that is organized under the laws of the United States or any state or political subdivision thereof.

(2) *Exposures to foreign PSEs.* (i) Except as provided in paragraphs (e)(1) and (e)(3) of this section, a System institution must assign a risk weight to a general obligation exposure to a foreign PSE, in accordance with Table 3 to § 628.32, based on the CRC that corresponds to the PSE's home country or the OECD membership status of the PSE's home country if there is no CRC applicable to the PSE's home country.

(ii) Except as provided in paragraphs (e)(1) and (e)(3) of this section, a System institution must assign a risk weight to a revenue obligation exposure to a foreign PSE, in accordance with Table 4 to § 628.32, based on the CRC that corresponds to the PSE's home country; or the OECD membership status of the PSE's home country if there is no CRC applicable to the PSE's home country.

(3) A System institution may assign a lower risk weight than would otherwise apply under Tables 3 and 4 to § 628.32 to an exposure to a foreign PSE if:

(i) The PSE's home country supervisor allows banks under its jurisdiction to assign a lower risk weight to such exposures; and

(ii) The risk weight is not lower than the risk weight that corresponds to the PSE's home country in accordance with Table 1 to § 628.32.

TABLE 3 TO § 628.32—RISK WEIGHTS FOR NON-U.S. PSE GENERAL OBLIGATIONS

	Risk weight (in percent)
CRC:	
0–1	20
2	50
3	100
4–7	150
OECD Member with No CRC	20
Non-OECD Member with No CRC	100
Sovereign Default	150

TABLE 4 TO § 628.32—RISK WEIGHTS FOR NON-U.S. PSE REVENUE OBLIGATIONS

	Risk weight (in percent)
CRC:	
0–1	50
2–3	100
4–7	150
OECD Member with No CRC	50
Non-OECD Member with No CRC	100
Sovereign Default	150

(4) *Exposures to PSEs from an OECD member sovereign with no CRC.* (i) A System institution must assign a 20-percent risk weight to a general obligation exposure to a PSE whose home country is a OECD member sovereign with no CRC.

(ii) A System institution must assign a 50-percent risk weight to a revenue obligation exposure to a PSE whose country is an OECD member sovereign with no CRC.

(5) *Exposures to PSEs whose home country is not an OECD member sovereign with no CRC.* A System institution must assign a 100-percent risk weight to an exposure to a PSE whose home country is not a member of the OECD and does not have a CRC.

(6) A System institution must assign a 150-percent risk weight to a PSE exposure immediately upon determining that an event of sovereign default has occurred in a PSE's home country or if an event of sovereign default has occurred in the PSE's home country during the previous 5 years.

(f) *Corporate exposures.* A System institution must assign a 100-percent risk weight to all its corporate exposures. Assets assigned a risk weight under this provision include:

(1) Borrower loans such as agricultural loans and consumer loans, regardless of the corporate form of the borrower, unless those loans qualify for different risk weights under other provisions of this subpart D;

(2) System bank exposures to OFIs that do not satisfy the requirements for a 20-percent risk weight pursuant to paragraph (d)(1) of this section; and

(3) Premises, fixed assets, and other real estate owned.

(g) *Residential mortgage exposures.*

(1) A System institution must assign a 50-percent risk weight to a first-lien residential mortgage exposure that:

(i) Is secured by a property that is either owner-occupied or rented; and
 (ii) Is made in accordance with prudent underwriting standards suitable for residential property, including standards relating to the loan amount as

a percent of the appraised value of the property;

(iii) Is not 90 days or more past due or carried in nonaccrual status; and

(iv) Is not restructured or modified.

(2) A System institution must assign a 100-percent risk weight to a first-lien residential mortgage exposure that does not meet the criteria in paragraph (g)(1) of this section, and to junior-lien residential mortgage exposures.

(3) For the purpose of this paragraph (g), if a System institution holds the first-lien and junior-lien(s) residential mortgage exposures, and no other party holds an intervening lien, the System institution must combine the exposures and treat them as a single first-lien residential mortgage exposure.

(4) A loan modified or restructured solely pursuant to the U.S. Treasury's Home Affordable Mortgage Program is not modified or restructured for purposes of this section.

(h) [Reserved]

(i) [Reserved]

(j) *High-volatility commercial real estate (HVCRE) exposures.* A System institution must assign a 150-percent risk weight to an HVCRE exposure.

(k) *Past due exposures.* Except for a sovereign exposure or a residential mortgage exposure, a System institution must determine a risk weight for an exposure that is 90 days or more past due or in nonaccrual status according to the requirements set forth in this paragraph.

(1) A System institution must assign a 150-percent risk weight to the portion of the exposure that is not guaranteed or that is not secured by financial collateral.

(2) A System institution may assign a risk weight to the guaranteed portion of a past due exposure based on the risk weight that applies under § 628.36 if the guarantee or credit derivative meets the requirements of that section.

(3) A System institution may assign a risk weight to the portion of a past due exposure that is collateralized by financial collateral based on the risk weight that applies under § 628.37 if the financial collateral meets the requirements of that section.

(l) *Other assets.* (1) A System institution must assign a 0-percent risk weight to cash owned and held in all offices of the System institution, in transit, or in accounts at a depository institution or a Federal Reserve Bank; to gold bullion held in a depository institution's vaults on an allocated basis, to the extent the gold bullion assets are offset by gold bullion liabilities; and to exposures that arise from the settlement of cash transactions (such as equities, fixed income, spot

foreign exchange (FX) and spot commodities) with a central counterparty where there is no assumption of ongoing counterparty credit risk by the central counterparty after settlement of the trade.

(2) A System institution must assign a 20-percent risk weight to cash items in the process of collection.

(3) A System institution must assign a 100-percent risk weight to deferred tax assets (DTAs) arising from temporary differences that the System institution could realize through net operating loss carrybacks.

(4) A System institution must assign a 100-percent risk weight to all MSAs.

(5) A System institution must assign a 100-percent risk weight to all assets that are not specifically assigned a different risk weight under this subpart and that are not deducted from tier 1 or tier 2 capital pursuant to § 628.22.

(6) [Reserved]

(m) *System institution exposure to other System institutions.* A System bank must assign a 20-percent risk weight to loans made to an association.

§ 628.33 Off-balance sheet exposures.

(a) *General.* (1) A System institution must calculate the exposure amount of an off-balance sheet exposure using the credit conversion factors (CCFs) in paragraph (b) of this section.

(2) Where a System institution commits to provide a commitment, the System institution may apply the lower of the two applicable CCFs.

(3) Where a System institution provides a commitment structured as a syndication or participation, the System institution is only required to calculate the exposure amount for its pro rata share of the commitment.

(4) Where a System institution provides a commitment, enters into a repurchase agreement, or provides a credit enhancing representation and warranty, and such commitment, repurchase agreement, or credit-enhancing representation and warranty is not a securitization exposure, the exposure amount shall be no greater than the maximum contractual amount of the commitment, repurchase agreement, or credit-enhancing representation and warranty, as applicable.

(5) The exposure amount of a System bank's commitment to an association is the difference between the association's maximum credit limit with the System bank (as established by the general financing agreement or promissory note, as required by § 614.4125(d)) and the amount the association has borrowed from the System bank.

(b) *Credit conversion factors*—(1) *Zero-percent (0%) CCF.* A System institution must apply a 0-percent CCF to the unused portion of a commitment that is unconditionally cancelable by the System institution.

(2) *Twenty-percent (20%) CCF.* A System institution must apply a 20-percent CCF to the amount of:

(i) Commitments with an original maturity of 14 months or less that are not unconditionally cancelable by the System institution.

(ii) Self-liquidating, trade-related contingent items that arise from the movement of goods, with an original maturity of 14 months or less.

(3) *Fifty-percent (50%) CCF.* A System institution must apply a 50-percent CCF to the amount of:

(i) Commitments with an original maturity of more than 14 months that are not unconditionally cancelable by the System institution.

(ii) Transaction-related contingent items, including performance bonds, bid bonds, warranties, and performance standby letters of credit.

(4) *One hundred-percent (100%) CCF.* A System institution must apply a 100-percent CCF to the following off-balance sheet items and other similar transactions:

(i) Guarantees;

(ii) Repurchase agreements (the off-balance sheet component of which equals the sum of the current fair values of all positions the System institution has sold subject to repurchase);

(iii) Credit-enhancing representations and warranties that are not securitization exposures;

(iv) Off-balance sheet securities lending transactions (the off-balance sheet component of which equals the sum of the current fair values of all positions the System institution has lent under the transaction);

(v) Off-balance sheet securities borrowing transactions (the off-balance sheet component of which equals the sum of the current fair values of all non-cash positions the System institution has posted as collateral under the transaction);

(vi) Financial standby letters of credit; and

(vii) Forward agreements.

§ 628.34 OTC derivative contracts.

(a) *Exposure amount*—(1) *Single OTC derivative contract.* Except as modified by paragraph (b) of this section, the exposure amount for a single OTC derivative contract that is not subject to a qualifying master netting agreement is equal to the sum of the System institution's current credit exposure and potential future credit exposure (PFE) on the OTC derivative contract.

(i) *Current credit exposure.* The current credit exposure for a single OTC derivative contract is the greater of the mark-to-fair value of the OTC derivative contract or 0.

(ii) *PFE.* (A) The PFE for a single OTC derivative contract, including an OTC derivative contract with a negative mark-to-fair value, is calculated by multiplying the notional principal amount of the OTC derivative contract by the appropriate conversion factor in Table 1 to § 628.34.

(B) For purposes of calculating either the PFE under this paragraph or the gross PFE under paragraph (a)(2) of this section for exchange rate contracts and other similar contracts in which the notional principal amount is equivalent to the cash flows, notional principal amount is the net receipts to each party falling due on each value date in each currency.

(C) For an OTC derivative contract that does not fall within one of the specified categories in Table 1 to § 628.34, the PFE must be calculated

using the appropriate “other” conversion factor.

(D) A System institution must use an OTC derivative contract’s effective notional principal amount (that is, the apparent or stated notional principal amount multiplied by any multiplier in the OTC derivative contract) rather than the apparent or stated notional principal amount in calculating PFE.

(E) The PFE of the protection provider of a credit derivative is capped at the net present value of the amount of unpaid premiums.

TABLE 1 TO § 628.34—CONVERSION FACTOR MATRIX FOR DERIVATIVE CONTRACTS ¹

Remaining maturity ²	Interest rate	Foreign exchange rate and gold	Credit (investment grade reference asset) ³	Credit (non-investment grade reference asset)	Equity	Precious metals (except gold)	Other
One (1) year or less	0.00	0.01	0.05	0.10	0.06	0.07	0.10
Greater than one (1) year and less than or equal to five (5) years	0.005	0.05	0.05	0.10	0.08	0.07	0.12
Greater than five (5) years	0.015	0.075	0.05	0.10	0.10	0.08	0.15

¹ For a derivative contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the derivative contract.

² For an OTC derivative contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the fair value of the contract is 0, the remaining maturity equals the time until the next reset date. For an interest rate derivative contract with a remaining maturity of greater than 1 year that meets these criteria, the minimum conversion factor is 0.005.

³ A System institution must use the column labeled “Credit (investment-grade reference asset)” for a credit derivative whose reference asset is an outstanding unsecured long-term debt security without credit enhancement that is investment grade. A System institution must use the column labeled “Credit (non-investment-grade reference asset)” for all other credit derivatives.

(2) *Multiple OTC derivative contracts subject to a qualifying master netting agreement.* Except as modified by paragraph (b) of this section, the exposure amount for multiple OTC derivative contracts subject to a qualifying master netting agreement is equal to the sum of the net current credit exposure and the adjusted sum of the PFE amounts for all OTC derivative contracts subject to the qualifying master netting agreement.

(i) *Net current credit exposure.* The net current credit exposure is the greater of the net sum of all positive and negative mark-to-fair values of the individual OTC derivative contracts subject to the qualifying master netting agreement or 0.

(ii) *Adjusted sum of the PFE amounts.* The adjusted sum of the PFE amounts, A_{net} , is calculated as $A_{net} = (0.4 \times A_{gross}) + (0.6 \times NGR \times A_{gross})$, where:

(A) A_{gross} = the gross PFE (that is, the sum of the PFE amounts (as determined under paragraph (a)(1)(ii) of this section for each individual derivative contract subject to the qualifying master netting agreement); and

(B) Net-to-gross Ratio (NGR) = the ratio of the net current credit exposure to the gross current credit exposure. In calculating the

NGR, the gross current credit exposure equals the sum of the positive current credit exposures (as determined under paragraph (a)(1)(i) of this section) of all individual derivative contracts subject to the qualifying master netting agreement.

(b) *Recognition of credit risk mitigation of collateralized OTC derivative contracts.* (1) A System institution may recognize the credit risk mitigation benefits of financial collateral that secures an OTC derivative contract or multiple OTC derivative contracts subject to a qualifying master netting agreement (netting set) by using the simple approach in § 628.37(b).

(2) Alternatively, if the financial collateral securing a contract or netting set described in paragraph (b)(1) of this section is marked-to-fair value on a daily basis and subject to a daily margin maintenance requirement, a System institution may recognize the credit risk mitigation benefits of financial collateral that secures the contract or netting set by using the collateral haircut approach in § 628.37(c).

(c) *Counterparty credit risk for OTC credit derivatives—(1) Protection purchasers.* A System institution that purchases an OTC credit derivative that is recognized under § 628.36 as a credit

risk mitigant is not required to compute a separate counterparty credit risk capital requirement under § 628.32 provided that the System institution does so consistently for all such credit derivatives. The System institution must either include all or exclude all such credit derivatives that are subject to a qualifying master netting agreement from any measure used to determine counterparty credit risk exposure to all relevant counterparties for risk-based capital purposes.

(2) *Protection providers.* (i) A System institution that is the protection provider under an OTC credit derivative must treat the OTC credit derivative as an exposure to the underlying reference asset. The System institution is not required to compute a counterparty credit risk capital requirement for the OTC credit derivative under § 628.32, provided that this treatment is applied consistently for all such OTC credit derivatives. The System institution must either include all or exclude all such OTC credit derivatives that are subject to a qualifying master netting agreement from any measure used to determine counterparty credit risk exposure.

(ii) The provisions of paragraph (c)(2) of this section apply to all relevant counterparties for risk-based capital purposes.

(d) *Counterparty credit risk for OTC equity derivatives.* (1) A System institution must treat an OTC equity derivative contract as an equity exposure and compute a risk-weighted asset amount for the OTC equity derivative contract under §§ 628.51 through 628.53.

(2) [Reserved]

(3) If the System institution risk weights the contract under the Simple Risk-Weight Approach (SRWA) in § 628.52, the System institution may choose not to hold risk-based capital against the counterparty credit risk of the OTC equity derivative contract, as long as it does so for all such contracts. Where the OTC equity derivative contracts are subject to a qualified master netting agreement, a System institution using the SRWA must either include all or exclude all of the contracts from any measure used to determine counterparty credit risk exposure.

(e) [Reserved]

§ 628.35 Cleared transactions.

(a) *General requirements*—(1) *Clearing member clients.* A System institution that is a clearing member client must use the methodologies described in paragraph (b) of this section to calculate risk-weighted assets for a cleared transaction.

(2) [Reserved]

(b) *Clearing member client System institutions*—(1) *Risk-weighted assets for cleared transactions.* (i) To determine the risk-weighted asset amount for a cleared transaction, a System institution that is a clearing member client must multiply the trade exposure amount for the cleared transaction, calculated in accordance with paragraph (b)(2) of this section, by the risk weight appropriate for the cleared transaction, determined in accordance with paragraph (b)(3) of this section.

(ii) A clearing member client System institution's total risk-weighted assets for cleared transactions is the sum of the risk-weighted asset amounts for all its cleared transactions.

(2) *Trade exposure amount.* (i) For a cleared transaction that is either a derivative contract or netting set of derivative contracts, the trade exposure amount equals:

(A) The exposure amount for the derivative contract or netting set of derivative contracts, calculated using the current exposure method (CEM) for

OTC derivative contracts under § 628.34, plus

(B) The fair value of the collateral posted by the clearing member client System institution and held by the central counterparty (CCP), clearing member, or custodian in a manner that is not bankruptcy remote.

(ii) For a cleared transaction that is a repo-style transaction, the trade exposure amount equals:

(A) The exposure amount for the repo-style transaction calculated using the collateral haircut methodology under § 628.37(c), plus

(B) The fair value of the collateral posted by the clearing member client System institution and held by the CCP or a clearing member in a manner that is not bankruptcy remote.

(3) *Cleared transaction risk weights.* (i) For a cleared transaction with a qualifying CCP (QCCP), a clearing member client System institution must apply a risk weight of:

(A) Two (2) percent if the collateral posted by the System institution to the QCCP or clearing member is subject to an arrangement that prevents any losses to the clearing member client System institution 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; and the clearing member client System institution has conducted sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review) that in the event of a legal challenge (including one resulting from default or from liquidation, insolvency, or receivership proceeding) the relevant court and administrative authorities would find the arrangements to be legal, valid, binding and enforceable under the law of the relevant jurisdictions; or

(B) Four (4) percent if the requirements of paragraph (b)(3)(i)(A) of this section are not met.

(ii) For a cleared transaction with a CCP that is not a QCCP, a clearing member client System institution must apply the risk weight appropriate for the CCP according to § 628.32.

(4) *Collateral.* (i) Notwithstanding any other requirements in this section, collateral posted by a clearing member client System institution that is held by a custodian (in its capacity as custodian) in a manner that is bankruptcy remote from the CCP, the custodian, clearing member and other clearing member clients of the clearing member, is not subject to a capital requirement under this section.

(ii) A clearing member client System institution must calculate a risk-

weighted asset amount for any collateral provided to a CCP, clearing member, or custodian in connection with a cleared transaction in accordance with the requirements under § 628.32.

(c) [Reserved]

(d) [Reserved]

§ 628.36 Guarantees and credit derivatives: substitution treatment.

(a) *Scope*—(1) *General.* A System institution may recognize the credit risk mitigation benefits of an eligible guarantee or eligible credit derivative by substituting the risk weight associated with the protection provider for the risk weight assigned to an exposure, as provided under this section.

(2) This section applies to exposures for which:

(i) Credit risk is fully covered by an eligible guarantee or eligible credit derivative; or

(ii) Credit risk is covered on a pro rata basis (that is, on a basis in which the System institution and the protection provider share losses proportionately) by an eligible guarantee or eligible credit derivative.

(3) Exposures on which there is a tranching of credit risk (reflecting at least two different levels of seniority) generally are securitization exposures subject to §§ 628.41 through 628.45.

(4) If multiple eligible guarantees or eligible credit derivatives cover a single exposure described in this section, a System institution may treat the hedged exposure as multiple separate exposures each covered by a single eligible guarantee or eligible credit derivative and may calculate a separate risk-weighted asset amount for each separate exposure as described in paragraph (c) of this section.

(5) If a single eligible guarantee or eligible credit derivative covers multiple hedged exposures described in paragraph (a)(2) of this section, a System institution must treat each hedged exposure as covered by a separate eligible guarantee or eligible credit derivative and must calculate a separate risk-weighted asset amount for each exposure as described in paragraph (c) of this section.

(b) *Rules of recognition.* (1) A System institution may only recognize the credit risk mitigation benefits of eligible guarantees and eligible credit derivatives.

(2) A System institution may only recognize the credit risk mitigation benefits of an eligible credit derivative to hedge an exposure that is different from the credit derivative's reference exposure used for determining the derivative's cash settlement value,

deliverable obligation, or occurrence of a credit event if:

(i) The reference exposure ranks *pari passu* with, or is subordinated to, the hedged exposure; and

(ii) The reference exposure and the hedged exposure are to the same legal entity, and legally enforceable cross-default or cross-acceleration clauses are in place to ensure payments under the credit derivative are triggered when the obligated party of the hedged exposure fails to pay under the terms of the hedged exposure.

(c) *Substitution approach*—(1) *Full coverage*. If an eligible guarantee or eligible credit derivative meets the conditions in paragraphs (a) and (b) of this section and the protection amount (P) of the guarantee or credit derivative is greater than or equal to the exposure amount of the hedged exposure, a System institution may recognize the guarantee or credit derivative in determining the risk-weighted asset amount for the hedged exposure by substituting the risk weight applicable to the guarantor or credit derivative protection provider under § 628.32 for the risk weight assigned to the exposure.

(2) *Partial coverage*. If an eligible guarantee or eligible credit derivative meets the conditions in §§ 628.36(a) and 628.37(b) and the protection amount (P) of the guarantee or credit derivative is less than the exposure amount of the hedged exposure, the System institution must treat the hedged exposure as two separate exposures (protected and unprotected) in order to recognize the credit risk mitigation benefit of the guarantee or credit derivative.

(i) The System institution may calculate the risk-weighted asset amount for the protected exposure under § 628.32, where the applicable risk weight is the risk weight applicable to the guarantor or credit derivative protection provider.

(ii) The System institution must calculate the risk-weighted asset amount for the unprotected exposure under § 628.32, where the applicable risk weight is that of the unprotected portion of the hedged exposure.

(iii) The treatment provided in this section is applicable when the credit risk of an exposure is covered on a partial pro rata basis and may be applicable when an adjustment is made to the effective notional amount of the guarantee or credit derivative under paragraphs (d), (e), or (f) of this section.

(d) *Maturity mismatch adjustment*. (1) A System institution that recognizes an eligible guarantee or eligible credit derivative in determining the risk-weighted asset amount for a hedged exposure must adjust the effective

notional amount of the credit risk mitigant to reflect any maturity mismatch between the hedged exposure and the credit risk mitigant.

(2) A maturity mismatch occurs when the residual maturity of a credit risk mitigant is less than that of the hedged exposure(s).

(3) The residual maturity of a hedged exposure is the longest possible remaining time before the obligated party of the hedged exposure is scheduled to fulfill its obligation on the hedged exposure. If a credit risk mitigant has embedded options that may reduce its term, the System institution (protection purchaser) must use the shortest possible residual maturity for the credit risk mitigant. If a call is at the discretion of the protection provider, the residual maturity of the credit risk mitigant is at the first call date. If the call is at the discretion of the System institution (protection purchaser), but the terms of the arrangement at origination of the credit risk mitigant contain a positive incentive for the System institution to call the transaction before contractual maturity, the remaining time to the first call date is the residual maturity of the credit risk mitigant.

(4) A credit risk mitigant with a maturity mismatch may be recognized only if its original maturity is greater than or equal to 1 year and its residual maturity is greater than 3 months.

(5) When a maturity mismatch exists, the System institution must apply the following adjustment to reduce the effective notional amount of the credit risk mitigant: $P_m = E \times [(t - 0.25) / (T - 0.25)]$,

where:

- (i) P_m = effective notional amount of the credit risk mitigant, adjusted for maturity mismatch;
- (ii) E = effective notional amount of the credit risk mitigant;
- (iii) t = the lesser of T or the residual maturity of the credit risk mitigant, expressed in years; and
- (iv) T = the lesser of 5 or the residual maturity of the hedged exposure, expressed in years.

(e) *Adjustment for credit derivatives without restructuring as a credit event*. If a System institution recognizes an eligible credit derivative that does not include as a credit event a restructuring of the hedged exposure involving forgiveness or postponement of principal, interest, or fees that results in a credit loss event (that is, a charge-off, specific provision, or other similar debit to the profit and loss account), the System institution must apply the following adjustment to reduce the

effective notional amount of the credit derivative: $P_r = P_m \times 0.60$,

where:

(1) P_r = effective notional amount of the credit risk mitigant, adjusted for lack of restructuring event (and maturity mismatch, if applicable); and

(2) P_m = effective notional amount of the credit risk mitigant (adjusted for maturity mismatch, if applicable).

(f) *Currency mismatch adjustment*. (1) If a System institution recognizes an eligible guarantee or eligible credit derivative that is denominated in a currency different from that in which the hedged exposure is denominated, the System institution must apply the following formula to the effective notional amount of the guarantee or credit derivative: $P_c = P_r \times (1 - H_{fx})$,

where:

- (i) P_c = effective notional amount of the credit risk mitigant, adjusted for currency mismatch (and maturity mismatch and lack of restructuring event, if applicable);
- (ii) P_r = effective notional amount of the credit risk mitigant (adjusted for maturity mismatch and lack of restructuring event, if applicable); and
- (iii) H_{fx} = haircut appropriate for the currency mismatch between the credit risk mitigant and the hedged exposure.

(2) A System institution must set H_{fx} equal to 8 percent.

(3) A System institution must adjust H_{fx} calculated in paragraph (f)(2) of this section upward if the System institution revalues the guarantee or credit derivative less frequently than once every 10 business days using the following square root of time formula:

$$H_{FX} = 8\% \sqrt{\frac{T_M}{10}}$$

where T_M equals the greater of 10 or the number of days between revaluation.

§ 628.37 Collateralized transactions.

(a) *General*. (1) To recognize the risk-mitigating effects of financial collateral, a System institution may use:

(i) The simple approach in paragraph (b) of this section for any exposure.

(ii) The collateral haircut approach in paragraph (c) of this section for repo-style transactions, eligible margin loans, collateralized derivative contracts, and single-product netting sets of such transactions.

(2) A System institution may use any approach described in this section that is valid for a particular type of exposure or transaction; however, it must use the same approach for similar exposures or transactions.

(b) *The simple approach*—(1) *General requirements.*

(i) A System institution may recognize the credit risk mitigation benefits of financial collateral that secures any exposure.

(ii) To qualify for the simple approach, the financial collateral must meet the following requirements:

(A) The collateral must be subject to a collateral agreement for at least the life of the exposure;

(B) The collateral must be revalued at least every 6 months; and

(C) The collateral (other than gold) and the exposure must be denominated in the same currency.

(2) *Risk-weight substitution.* (i) A System institution may apply a risk weight to the portion of an exposure that is secured by the fair value of financial collateral (that meets the requirements of paragraph (b)(1) of this section) based on the risk weight assigned to the collateral under § 628.32. For repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions, the collateral is the instruments, gold, and cash the System institution has borrowed, purchased subject to resale, or taken as collateral from the counterparty under the transaction. Except as provided in paragraph (b)(3) of this section, the risk weight assigned to the collateralized portion of the exposure may not be less than 20 percent.

(ii) A System institution must apply a risk weight to the unsecured portion of the exposure based on the risk weight assigned to the exposure under this subpart.

(3) *Exceptions to the 20-percent risk-weight floor and other requirements.* Notwithstanding paragraph (b)(2)(i) of this section:

(i) A System institution may assign a 0-percent risk weight to an exposure to an OTC derivative contract that is marked-to-fair on a daily basis and subject to a daily margin maintenance

requirement, to the extent the contract is collateralized by cash on deposit.

(ii) A System institution may assign a 10-percent risk weight to an exposure to an OTC derivative contract that is marked-to-fair value daily and subject to a daily margin maintenance requirement, to the extent that the contract is collateralized by an exposure to a sovereign that qualifies for a 0-percent risk weight under § 628.32.

(iii) A System institution may assign a 0-percent risk weight to the collateralized portion of an exposure where:

(A) The financial collateral is cash on deposit; or

(B) The financial collateral is an exposure to a sovereign that qualifies for a 0-percent risk weight under § 628.32, and the System institution has discounted the fair value of the collateral by 20 percent.

(c) *Collateral haircut approach* — (1) *General.* A System institution may recognize the credit risk mitigation benefits of financial collateral that secures an eligible margin loan, repo-style transaction, collateralized derivative contract, or single-product netting set of such transactions by using the standard supervisory haircuts in paragraph (c)(3) of this section.

(2) *Exposure amount equation.* A System institution must determine the exposure amount for an eligible margin loan, repo-style transaction, collateralized derivative contract, or a single-product netting set of such transactions by setting the exposure amount equal to $\max \{0, [(\Sigma E - \Sigma C) + \Sigma (E_s \times H_s) + \Sigma (E_{fx} \times H_{fx})]\}$,

where:

(i)(A) For eligible margin loans and repo-style transactions and netting sets thereof, ΣE equals the value of the exposure (the sum of the current fair values of all instruments, gold, and cash the System institution has lent, sold subject to repurchase, or posted as collateral to the counterparty under the transaction (or netting set)); and

(B) For collateralized derivative contracts and netting sets thereof, ΣE equals the exposure amount of the OTC derivative contract (or netting set) calculated under § 628.34(c) or (d).

(ii) ΣC equals the value of the collateral (the sum of the current fair values of all instruments, gold and cash the System institution has borrowed, purchased subject to resale, or taken as collateral from the counterparty under the transaction (or netting set));

(iii) E_s equals the absolute value of the net position in a given instrument or in gold (where the net position in the instrument or gold equals the sum of the current fair values of the instrument or gold the System institution has lent, sold subject to repurchase, or posted as collateral to the counterparty minus the sum of the current fair values of that same instrument or gold the System institution has borrowed, purchased subject to resale, or taken as collateral from the counterparty);

(iv) H_s equals the fair value price volatility haircut appropriate to the instrument or gold referenced in E_s ;

(v) E_{fx} equals the absolute value of the net position of instruments and cash in a currency that is different from the settlement currency (where the net position in a given currency equals the sum of the current fair values of any instruments or cash in the currency the System institution has lent, sold subject to repurchase, or posted as collateral to the counterparty minus the sum of the current fair values of any instruments or cash in the currency the System institution has borrowed, purchased subject to resale, or taken as collateral from the counterparty); and

(vi) H_{fx} equals the haircut appropriate to the mismatch between the currency referenced in E_{fx} and the settlement currency.

(3) *Standard supervisory haircuts.* (i) A System institution must use the haircuts for fair value price volatility (H_s) provided in Table 1 to § 628.37, as adjusted in certain circumstances in accordance with the requirements of paragraphs (c)(3)(iii) and (iv) of this section:

TABLE 1 TO § 628.37—STANDARD SUPERVISORY MARKET PRICE VOLATILITY HAIRCUT ¹

Residual maturity	Haircut (in percent) assigned based on						Investment grade securization exposures (in percent)
	Sovereign issuers risk weight under § 628.3 ²			Non-sovereign issuers risk weight under § 628.32			
	Zero	20% or -50%	100%	20%	50%	100%	
Less than or equal to 1 year	0.5	1.0	15.0	1.0	2.0	25.0	4%
Greater than 1 years and less than and equal to 5 years	2.0	3.0	15.0	4.0	6.0	25.0	12%
Greater than 5 years	4.0	6.0	15.0	8.0	12.0	25.0	24%
Main index equities (including convertible bonds) and gold							15%
Other publically traded equities (including convertible bonds)							25%

TABLE 1 TO § 628.37—STANDARD SUPERVISORY MARKET PRICE VOLATILITY HAIRCUT ¹—Continued

Residual maturity	Haircut (in percent) assigned based on						Investment grade securitization exposures (in percent)
	Sovereign issuers risk weight under § 628.3 ²			Non-sovereign issuers risk weight under § 628.32			
	Zero	20% or –50%	100%	20%	50%	100%	
Mutual funds	Highest haircut applicable to any security in which the fund can invest						
Cash collateral	0%						

¹ The market price volatility haircut in Table 1 to § 628.37 are based on 10-day holding period.
² Includes a foreign PSE that receives a 0-percent risk weight.

(ii) For currency mismatches, a System institution must use a haircut for foreign exchange rate volatility (Hfx) of 8 percent, as adjusted in certain circumstances under paragraphs (c)(3)(iii) and (iv) of this section.

(iii) For repo-style transactions, a System institution may multiply the standard supervisory haircuts provided in paragraphs (c)(3)(i) and (ii) of this section by the square root of 1/2 (which equals 0.707107).

(iv) If the number of trades in a netting set exceeds 5,000 at any time during a quarter, a System institution must adjust the supervisory haircuts provided in paragraphs (c)(3)(i) and (ii) of this section upward on the basis of a holding period of 20 business days for the following quarter except in the calculation of the exposure amount for purposes of § 628.35. If a netting set contains one or more trades involving illiquid collateral or an OTC derivative that cannot be easily replaced, a System institution must adjust the supervisory haircuts upward on the basis of a holding period of 20 business days. If over the 2 previous quarters more than two margin disputes on a netting set have occurred that lasted more than the holding period, then the System institution must adjust the supervisory haircuts upward for that netting set on the basis of a holding period that is at least two times the minimum holding period for that netting set. A System institution must adjust the standard supervisory haircuts upward using the following formula:

$$H_A = H_S \sqrt{\frac{T_M}{T_S}}, \text{ where}$$

where

(A) T_M equals a holding period of longer than 10 business days for eligible margin loans and derivative contracts or longer than 5 business days for repo-style transactions;

(B) H_S equals the standard supervisory haircut; and

(C) T_S equals 10 business days for eligible margin loans and derivative contracts or 5 business days for repo-style transactions.

(v) If the instrument a System institution has lent, sold subject to repurchase, or posted as collateral does not meet the definition of financial collateral in § 628.2, the System institution must use a 25-percent haircut for fair value price volatility (H_S).

(4) [Reserved]

Risk-Weighted Assets for Unsettled Transactions

§ 628.38 Unsettled transactions.

(a) *Definitions.* For purposes of this section:

(1) Delivery-versus-payment (DvP) transaction means a securities or commodities transaction in which the buyer is obligated to make payment only if the seller has made delivery of the securities or commodities and the seller is obligated to deliver the securities or commodities only if the buyer has made payment.

(2) Payment-versus-payment (PvP) transaction means a foreign exchange transaction in which each counterparty is obligated to make a final transfer of one or more currencies only if the other counterparty has made a final transfer of one or more currencies.

(3) A transaction has a normal settlement period if the contractual settlement period for the transaction is equal to or less than the fair value standard for the instrument underlying the transaction and equal to or less than 5 business days.

(4) Positive current exposure of a System institution for a transaction is the difference between the transaction value at the agreed settlement price and the current fair value price of the transaction, if the difference results in a credit exposure of the System institution to the counterparty.

(b) *Scope.* This section applies to all transactions involving securities, foreign exchange instruments, and commodities

that have a risk of delayed settlement or delivery. This section does not apply to:

(1) Cleared transactions that are marked-to-fair value daily and subject to daily receipt and payment of variation margin;

(2) Repo-style transactions, including unsettled repo-style transactions;

(3) One-way cash payments on OTC derivative contracts; or

(4) Transactions with a contractual settlement period that is longer than the normal settlement period (which are treated as OTC derivative contracts as provided in § 628.34).

(c) *System-wide failures.* In the case of a system-wide failure of a settlement, clearing system or central counterparty, the FCA may waive risk-based capital requirements for unsettled and failed transactions until the situation is rectified.

(d) *Delivery-versus-payment (DvP) and payment-versus-payment (PvP) transactions.* A System institution must hold risk-based capital against any DvP or PvP transaction with a normal settlement period if the System institution's counterparty has not made delivery or payment within 5 business days after the settlement date. The System institution must determine its risk-weighted asset amount for such a transaction by multiplying the positive current exposure of the transaction for the System institution by the appropriate risk weight in Table 1 to § 628.38.

TABLE 1 TO § 628.38—RISK WEIGHTS FOR UNSETTLED DVP AND PVP TRANSACTIONS

Number of business days after contractual settlement date	Risk weight to be applied to positive current exposure (in percent)
From 5 to 15	100.0
From 16 to 30	625.0
From 31 to 45	937.5

TABLE 1 TO § 628.38—RISK WEIGHTS FOR UNSETTLED DvP AND PVP TRANSACTIONS—Continued

Number of business days after contractual settlement date	Risk weight to be applied to positive current exposure (in percent)
46 or more	1,250.0

(e) *Non-DvP/non-PvP (non-delivery-versus-payment/non-payment-versus-payment) transactions.* (1) A System institution must hold risk-based capital against any non-DvP/non-PvP transaction with a normal settlement period if the System institution has delivered cash, securities, commodities, or currencies to its counterparty but has not received its corresponding deliverables by the end of the same business day. The System institution must continue to hold risk-based capital against the transaction until the System institution has received its corresponding deliverables.

(2) From the business day after the System institution has made its delivery until 5 business days after the counterparty delivery is due, the System institution must calculate the risk-weighted asset amount for the transaction by treating the current fair value of the deliverables owed to the System institution as an exposure to the counterparty and using the applicable counterparty risk weight under § 628.32.

(3) If the System institution has not received its deliverables by the 5th business day after counterparty delivery was due, the System institution must assign a 1,250-percent risk weight to the current fair value of the deliverables owed to the System institution.

(f) *Total risk-weighted assets for unsettled transactions.* Total risk-weighted assets for unsettled transactions is the sum of the risk-weighted asset amounts of all DvP, PvP, and non-DvP/non-PvP transactions. ≤ §§ 628.39 through 628.40 [Reserved]

Risk-Weighted Assets for Securitization Exposures

§ 628.41 Operational requirements for securitization exposures.

(a) *Operational criteria for traditional securitizations.* A System institution that transfers exposures it has originated or purchased to a third party in connection with a traditional securitization may exclude the exposures from the calculation of its risk-weighted assets only if each condition in this section is satisfied. A System institution that meets these

conditions must hold risk-based capital against any credit risk it retains in connection with the securitization. A System institution that fails to meet these conditions must hold risk-based capital against the transferred exposures as if they had not been securitized and must deduct from CET1 capital, pursuant to § 628.22, any after-tax gain-on-sale resulting from the transaction. The conditions are:

(1) The exposures are not reported on the System institution's consolidated balance sheet under GAAP;

(2) The System institution has transferred to one or more third parties credit risk associated with the underlying exposures;

(3) Any clean-up calls relating to the securitization are eligible clean-up calls; and

(4) The securitization does not:

(i) Include one or more underlying exposures in which the borrower is permitted to vary the drawn amount within an agreed limit under a line of credit; and

(ii) Contain an early amortization provision.

(b) *Operational criteria for synthetic securitizations.* For synthetic securitizations, a System institution may recognize for risk-based capital purposes the use of a credit risk mitigant to hedge underlying exposures only if each condition in this paragraph is satisfied. A System institution that meets these conditions must hold risk-based capital against any credit risk of the exposures it retains in connection with the synthetic securitization. A System institution that fails to meet these conditions or chooses not to recognize the credit risk mitigant for purposes of this section must instead hold risk-based capital against the underlying exposures as if they had not been synthetically securitized. The conditions are:

(1) The credit risk mitigant is:

(i) Financial collateral;

(ii) A guarantee that meets all criteria set forth in the definition of "eligible guarantee" in § 628.2, except for the criteria in paragraph (3) of that definition; or

(iii) A credit derivative that meets all criteria as set forth in the definition of "eligible credit derivative" in § 628.2, except for the criteria in paragraph (3) of the definition of "eligible guarantee" in § 628.2.

(2) The System institution transfers credit risk associated with the underlying exposures to one or more third parties, and the terms and conditions in the credit risk mitigants employed do not include provisions that:

(i) Allow for the termination of the credit protection due to deterioration in the credit quality of the underlying exposures;

(ii) Require the System institution to alter or replace the underlying exposures to improve the credit quality of the pool of underlying exposures;

(iii) Increase the System institution's cost of credit protection in response to deterioration in the credit quality of the underlying exposures;

(iv) Increase the yield payable to parties other than the System institution in response to a deterioration in the credit quality of the underlying exposures; or

(v) Provide for increases in a retained first loss position or credit enhancement provided by the System institution after the inception of the securitization;

(3) The System institution obtains a well-reasoned opinion from legal counsel that confirms the enforceability of the credit risk mitigant in all relevant jurisdictions; and

(4) Any clean-up calls relating to the securitization are eligible clean-up calls.

(c) *Due diligence requirements.* (1) Except for exposures that are deducted from CET1 capital (pursuant to § 628.22) and exposures subject to § 628.42(h), if a System institution is unable to demonstrate to the satisfaction of the FCA a comprehensive understanding of the features of a securitization exposure that would materially affect the performance of the exposure, the System institution must assign the securitization exposure a risk weight of 1,250 percent. The System institution's analysis must be commensurate with the complexity of the securitization exposure and the materiality of the exposure in relation to its capital.

(2) A System institution must demonstrate its comprehensive understanding of a securitization exposure under paragraph (c)(1) of this section for each securitization exposure by:

(i) Conducting an analysis of the risk characteristics of a securitization exposure prior to acquiring the exposure, and documenting such analysis within 3 business days after acquiring the exposure, considering:

(A) Structural features of the securitization that would materially impact the performance of the exposure, for example, the contractual cash flow waterfall, waterfall-related triggers, credit enhancements, liquidity enhancements, fair value triggers, the performance of organizations that service the exposure, and deal-specific definitions of default;

(B) Relevant information regarding the performance of the underlying credit

exposure(s), for example, the percentage of loans 30, 60, and 90 days past due; default rates; prepayment rates; loans in foreclosure; property types; occupancy; average credit score or other measures of creditworthiness; average loan-to-value (LTV) ratio; and industry and geographic diversification data on the underlying exposure(s);

(C) Relevant market data of the securitization, for example, bid-ask spread, most recent sales price and historic price volatility, trading volume, implied market rating, and size, depth and concentration level of the market for the securitization; and

(D) For resecuritization exposures, performance information on the underlying securitization exposures, for example, the issuer name and credit quality, and the characteristics and performance of the exposures; and

(ii) On an on-going basis (no less frequently than quarterly), evaluating, reviewing, and updating as appropriate the analysis required under paragraph (c)(1) of this section for each securitization exposure.

§ 628.42 Risk-weighted assets for securitization exposures.

(a) *Securitization risk weight approaches.* Except as provided elsewhere in this section or in § 628.41:

(1) A System institution must deduct from CET1 capital any after-tax gain-on-sale resulting from a securitization (as provided in § 628.22) and must apply a 1,250-percent risk weight to the portion of a credit-enhancing interest-only strip (CEIO) that does not constitute after-tax gain-on-sale.

(2) If a securitization exposure does not require deduction under paragraph (a)(1) of this section, a System institution may assign a risk weight to the securitization exposure using the simplified supervisory formula approach (SSFA) in accordance with § 628.43(a) through (d) and subject to the limitation under § 628.42(e). Alternatively, a System institution may assign a risk weight to the purchased securitization exposure using the gross-up approach in accordance with § 628.43(e), provided however, that such System institution must apply either the SSFA or the gross-up approach consistently across all of its securitization exposures, except as provided in paragraphs (a)(1), (a)(3), and (a)(4) of this section.

(3) If a securitization exposure does not require deduction under paragraph (a)(1) of this section and the System institution cannot or chooses not to apply the SSFA or the gross-up approach to the exposure, the System

institution must assign a risk weight to the exposure as described in § 628.44.

(4) If a securitization exposure is a derivative contract (other than protection provided by a System institution in the form of a credit derivative) that has a first priority claim on the cash flows from the underlying exposures (notwithstanding amounts due under interest rate or currency derivative contracts, fees due, or other similar payments), a System institution may choose to set the risk-weighted asset amount of the exposure equal to the amount of the exposure as determined in paragraph (c) of this section.

(b) *Total risk-weighted assets for securitization exposures.* A System institution's total risk-weighted assets for securitization exposures equals the sum of the risk-weighted asset amount for securitization exposures that the System institution risk weights under §§ 628.41(c), 628.42(a)(1), and 628.43, 628.44, or 628.45, except as provided in § 628.42(e) through (j) of this section, as applicable.

(c) *Exposure amount of a securitization exposure.*

(1) [Reserved]

(2) *On-balance sheet securitization exposures (available-for-sale or held-to-maturity securities).* The exposure amount of an on-balance sheet securitization exposure that is an available-for-sale or held-to-maturity security is the System institution's carrying value (including net accrued but unpaid interest and fees), less any net unrealized gains on the exposure and plus any net unrealized losses on the exposure.

(3) *Off-balance sheet securitization exposures.* (i) Except as provided in paragraph (j) of this section, the exposure amount of an off-balance sheet securitization that is not a repo-style transaction, an eligible margin loan, a cleared transaction (other than a credit derivative), or an OTC derivative contract (other than a credit derivative) is the notional amount of the exposure.

(ii) [Reserved]

(iii) [Reserved]

(4) *Repo-style transactions, eligible margin loans, and derivative contracts.* The exposure amount of a securitization exposure that is a repo-style transaction, an eligible margin loan, or a derivative contract (other than a credit derivative) is the exposure amount of the transaction as calculated under § 628.34 or § 628.37 as applicable.

(d) *Overlapping exposures.* If a System institution has multiple securitization exposures that provide duplicative coverage to the underlying exposures of a securitization, the

System institution is not required to hold duplicative risk-based capital against the overlapping position. Instead, the System institution may apply to the overlapping position the applicable risk-based capital treatment that results in the highest risk-based capital requirement.

(e) *Implicit support.* If a System institution provides support to a securitization in excess of the System institution's contractual obligation to provide credit support to the securitization (implicit support):

(1) The System institution must include in risk-weighted assets all of the underlying exposures associated with the securitization as if the exposures had not been securitized and must deduct from CET1 capital (pursuant to § 628.22) any after-tax gain-on-sale resulting from the securitization; and

(2) The System institution must disclose publicly:

(i) That it has provided implicit support to the securitization; and

(ii) The risk-based capital impact to the System institution of providing such implicit support.

(f) *Undrawn portion of an eligible servicer cash advance facility.* (1) Notwithstanding any other provision of this subpart, a System institution that is a servicer under an eligible servicer cash advance facility is not required to hold risk-based capital against potential future cash advance payments that it may be required to provide under the contract governing the facility.

(2) For a System institution that acts as a servicer, the exposure amount for a servicer cash advance facility that is not an eligible cash advance facility is equal to the amount of all potential future cash payments that the System institution may be contractually required to provide during the subsequent 12-month period under the governing facility.

(g) *Interest-only mortgage-backed securities.* Regardless of any other provisions of this subpart, the risk weight for a non-credit-enhancing interest-only mortgage-backed security may not be less than 100 percent.

(h) *Small-business loans and leases on personal property transferred with retained contractual exposure.* (1) Regardless of any other provisions of this subpart, a System institution that has transferred small-business loans and leases on personal property (small-business obligations) must include in risk-weighted assets only its contractual exposure to the small-business obligations if all the following conditions are met:

(i) The transaction must be treated as a sale under GAAP.

(ii) The System institution establishes and maintains, pursuant to GAAP, a non-capital reserve sufficient to meet the System institution's reasonably estimated liability under the contractual obligation.

(iii) The small business obligations are to businesses that meet the criteria for a small-business concern established by the Small Business Administration under section 3(a) of the Small Business Act.

(iv) [Reserved]

(2) The total outstanding amount of contractual exposure retained by a System institution on transfers of small-business obligations receiving the capital treatment specified in paragraph (h)(1) of this section cannot exceed 15 percent of the System institution's total capital.

(3) If a System institution exceeds the 15-percent capital limitation provided in paragraph (h)(2) of this section, the capital treatment under paragraph (h)(1) of this section will continue to apply to any transfers of small-business obligations with retained contractual exposure that occurred during the time that the System institution did not exceed the capital limit.

(4) [Reserved]

(i) [Reserved]; and

(ii) [Reserved]

(i) *Nth-to-default credit derivatives. (1) Protection provider.* A System institution must assign a risk weight to an Nth-to-default credit derivative in accordance with FCA guidance.

(2) [Reserved]

(3) [Reserved]

(4) *Protection purchaser* — (i) *First-to-default credit derivatives.* A System institution that obtains credit protection on a group of underlying exposures through a first-to-default credit derivative that meets the rules of recognition of § 628.36(b) must determine its risk-based capital requirement for the underlying exposures as if the System institution synthetically securitized the underlying exposure with the smallest risk-weighted asset amount and had obtained no credit risk mitigant on the other underlying exposures. A System institution must calculate a risk-based capital requirement for counterparty credit risk according to § 628.34 for a first-to-default credit derivative that does not meet the rules of recognition of § 628.36(b).

(ii) *Second-or-subsequent-to-default credit derivatives.* (A) A System institution that obtains credit protection on a group of underlying exposures through a Nth-to-default credit derivative that meets the rules of recognition of § 628.36(b) (other than a

first-to-default credit derivative) may recognize the credit risk mitigation benefits of the derivative only if:

(1) The System institution also has obtained credit protection on the same underlying exposures in the form of first-through-(n-1)-to-default credit derivatives; or

(2) If n-1 of the underlying exposures have already defaulted.

(B) If a System institution satisfies the requirements of paragraph (i)(4)(ii)(A) of this section, the System institution must determine its risk-based capital requirement for the underlying exposures as if the System institution had only symmetrically securitized the underlying exposure with the Nth smallest risk-weighted asset amount and had obtained no credit risk mitigant on the underlying exposures.

(C) A System institution must calculate a risk-based capital requirement for counterparty credit risk according to § 628.34 for a Nth-to-default credit derivative that does not meet the rules of recognition of § 628.36(b).

(j) *Guarantees and credit derivatives other than Nth-to-default credit derivatives* — (1) *Protection provider.*

For a guarantee or credit derivative (other than an Nth-to-default credit derivative) provided by a System institution that covers the full amount or a pro rata share of a securitization exposure's principal and interest, the System institution must risk weight the guarantee or credit derivative in accordance with FCA guidance.

(2) *Protection purchaser.* (i) A System institution that purchases a guarantee or OTC credit derivative (other than an Nth-to-default credit derivative) that is recognized under § 628.45 as a credit risk mitigant (including via collateral recognized under § 628.37) is not required to compute a separate credit risk capital requirement under § 628.31, in accordance with § 628.34(c).

(ii) If a System institution cannot, or chooses not to, recognize a purchased credit derivative as a credit risk mitigant under § 628.45, the System institution must determine the exposure amount of the credit derivative under § 628.34.

(A) If the System institution purchases credit protection from a counterparty that is not a securitization special purpose entity (SPE), the System institution must determine the risk weight for the exposure according to general risk weights under § 628.32.

(B) If the System institution purchases the credit protection from a counterparty that is a securitization SPE, the System institution must determine the risk weight for the exposure according to § 628.42,

including § 628.42(a)(4) for a credit derivative that has a first priority claim on the cash flows from the underlying exposures of the securitization SPE (notwithstanding amounts due under interest rate or currency derivative contracts, fees due, or other similar payments).

§ 628.43 Simplified supervisory formula approach (SSFA) and the gross-up approach.

(a) *General requirements for the SSFA.* To use the SSFA to determine the risk weight for a securitization exposure, a System institution must have data that enables it to assign accurately the parameters described in paragraph (b) of this section. Data used to assign the parameters described in paragraph (b) of this section must be the most currently available data; if the contract governing the underlying exposures of the securitization require payment on a monthly or quarterly basis, the data used to assign the parameters described in paragraph (b) of this section must be no more than 91 calendar days old. A System institution that does not have the appropriate data to assign the parameters described in paragraph (b) of this section must assign a risk weight of 1,250 percent to the exposure.

(b) *SSFA parameters.* To calculate the risk weight for a securitization exposure using the SSFA, a System institution must have accurate information on the following five inputs to the SSFA calculation:

(1) K_G is the weighted-average (with unpaid principal used as the weight for each exposure) total capital requirement of the underlying exposures calculated using this subpart. K_G is expressed as a decimal value between 0 and 1 (that is, an average risk weight of 100 percent represents a value of K_G equal to .08).

(2) Parameter W is expressed as a decimal value between 0 and 1. Parameter W is the ratio of the sum of the dollar amounts of any underlying exposures within the securitized pool that meet any of the criteria as set forth in paragraphs (b)(2)(i) through (vi) of this section to the balance, measured in dollars, of underlying exposures:

- (i) Ninety (90) days or more past due;
- (ii) Subject to a bankruptcy or insolvency proceeding;
- (iii) In the process of foreclosure;
- (iv) Held as real estate owned;
- (v) Has contractually deferred interest payments for 90 days or more, other than principal or interest payments deferred on:

(A) Federally guaranteed student loans, in accordance with the terms of those guarantee programs; or

(B) Consumer loans, including non-federally guaranteed student loans, provided that such payments are deferred pursuant to provisions included in the contract at the time funds are disbursed that provide for periods(s) of deferral that are not initiated based on changes in the creditworthiness of the borrower; or

(vi) Is in default.

(3) Parameter A is the attachment point for the exposure, which represents the threshold at which credit losses will first be allocated to the exposure. Except as provided in § 628.42(i) for n^{th} -to-default credit derivatives, parameter A equals the ratio of the current dollar amount of underlying exposures that are subordinated to the exposure of the System institution to the current dollar amount of underlying exposures. Any reserve account funded by the accumulated cash flows from the underlying exposures that is subordinated to the System institution's securitization exposure may be included in the calculation of parameter A to the extent that cash is present in the

account. Parameter A is expressed as a decimal value between 0 and 1.

(4) Parameter D is the detachment point for the exposure, which represents the threshold at which credit losses of principal allocated to the exposure would result in a total loss of principal. Except as provided in § 628.42(i) for n^{th} -to-default credit derivatives, parameter D equals parameter A plus the ratio of the current dollar amount of the securitization exposures that are *pari passu* with the exposure (that is, have equal seniority with respect to credit risk) to the current dollar amount of the underlying exposures. Parameter D is expressed as a decimal value between 0 and 1.

(5) A supervisory calibration parameter, p , is equal to 0.5 for securitization exposures that are not resecuritization exposures and equal to 1.5 for resecuritization exposures.

(c) *Mechanics of the SSFA.* K_g and W are used to calculate K_A , the augmented value of K_g , which reflects the observed credit quality of the underlying pool of exposures. K_A is defined in paragraph (d) of this section. The values of

parameters A and D , relative to K_A determine the risk weight assigned to a securitization exposure as described in paragraph (d) of this section. The risk weight assigned to a securitization exposure, or portion of a exposure, as appropriate, is the larger of the risk weight determined in accordance with this paragraph (d) of this section and a risk weight of 20 percent.

(1) When the detachment point, parameter D , for a securitization exposure is less than or equal to K_A the exposure must be assigned a risk weight of 1,250 percent.

(2) When the attachment point, parameter A , for a securitization exposure is greater than or equal to K_A the System institution must calculate the risk weight in accordance with paragraph (d) of this section.

(3) When A is less than K_A and D is greater than K_A , the risk weight is a weighted average of 1,250 percent and 1,250 percent times K_{SSFA} calculated in accordance with paragraph (d) of this section. For the purpose of this weighted-average calculation:

(i) The weight assigned to 1,250 percent equals $\frac{K_A - A}{D - A}$.

(ii) The weight assigned to 1,250 percent times K_{SSFA} equals $\frac{D - K_A}{D - A}$.

(iii) The risk weight will be set equal to:

$$RW = \left[\left(\frac{K_A - A}{D - A} \right) \times 1,250 \text{ percent} \right] + \left[\left(\frac{D - K_A}{D - A} \right) \times 1,250 \text{ percent} \times K_{SSFA} \right]$$

(d) *SSFA equation.*

(1) The System institution must define the following parameters:

$$K_A = (1 - W) \times K_G + (0.5 \times W)$$

$$a = \frac{1}{p \times K_A}$$

$$u = D - K_A$$

$$l = \max(A - K_A, 0)$$

$e=2.71828$, the base of the natural logarithms.

(2) Then the System institution must calculate K_{SSFA} according to the following equation:

$$K_{SSFA} = \frac{e^{au} - e^{al}}{a(u \times l)}$$

(3) The risk weight for the exposure (expressed as a percent) is equal to $K_{SSFA} \times 1,250$.

(e) *Gross-up approach* — (1) *Applicability.* A System institution may apply the gross-up approach set forth in this section instead of the SSFA to determine the risk weight of its securitization exposures, provided that it applies the gross-up approach to all of its securitization exposures, except as otherwise provided for certain securitization exposures in §§ 628.44 and 628.45.

(2) To use the gross-up approach, a System institution must calculate the following four inputs:

(i) Pro rata share A , which is the par value of the System institution's securitization exposure X as a percent of the par value of the tranche in which the securitization exposure resides Y ; $A = X/Y$ expressed as a percent;

(ii) Enhanced amount B , which is the value of tranches that are more senior to the tranche in which the System institution's securitization resides; are more senior to the tranche in which the System institution's securitization resides;

(iii) Exposure amount of the System institution's securitization exposure calculated under § 628.42(c) $C = \text{carrying value of exposure}$; and

(iv) Risk weight (RW) which is the weighted-average risk weight of underlying exposures in the securitization pool as calculated under this subpart. For example, RW for an asset-backed security with underlying car loans would be 100 percent.

(3) *Credit equivalent amount (CEA).* The CEA of a securitization exposure under this section equals the sum of:

(i) The exposure amount C of the System institution's securitization exposure, plus

(ii) the pro rata share A multiplied by the enhanced amount B , each calculated in accordance with paragraph (e)(2) of this section.

$$CEA = C + (A \times B)$$

(4) *Risk-weighted assets (RWA).* To calculate RWA for a securitization exposure under the gross-up approach, a System institution must apply the RW calculated under paragraph (e)(2) of this section to the CEA calculated in paragraph (e)(3) of this section.

$RWA = RW \times CEA$

(f) *Limitations.* Notwithstanding any other provision of this section, a System institution must assign a risk weight of not less than 20 percent to a securitization exposure.

§ 628.44 Securitization exposures to which the SSFA and gross-up approach do not apply.

(a) *General requirement.* A System institution must assign a 1,250-percent risk weight to all securitization exposures to which the System institution does not apply the SSFA or the gross up approach under § 628.43.

(b) [Reserved]

(c) [Reserved]

§ 628.45 Recognition of credit risk mitigants for securitization exposures.

(a) *General.* (1) An originating System institution that has obtained a credit risk mitigant to hedge its exposure to a synthetic or traditional securitization that satisfies the operational criteria provided in § 628.41 may recognize the credit risk mitigant under §§ 628.36 or 628.37, but only as provided in this section.

(2) An investing System institution that has obtained a credit risk mitigant to hedge a securitization exposure may recognize the credit risk mitigant under §§ 628.36 or 628.37, but only as provided in this section.

(b) *Mismatches.* A System institution must make any applicable adjustment to the protection amount of an eligible guarantee or credit derivative as required in § 628.36(d), (e), and (f) for any hedged securitization exposure. In the context of a synthetic securitization, when an eligible guarantee or eligible credit derivative covers multiple hedged exposures that have different residual maturities, the System institution must use the longest residual maturity of any of the hedged exposures as the residual maturity of all hedged exposures.

§§ 628.46 through 628.50 [Reserved]

Risk-Weighted Assets for Equity Exposures

§ 628.51 Introduction and exposure measurement.

(a) *General.* (1) To calculate its risk-weighted asset amounts for equity exposures that are not equity exposures to an investment fund, a System institution must use the Simple Risk-Weight Approach (SRWA) provided in § 628.52. A System institution must use the look-through approaches provided in § 628.53 to calculate its risk-weighted asset amounts for equity exposures to investment funds.

(2) [Reserved]

(3) [Reserved]

(b) *Adjusted carrying value.* For purposes of §§ 628.51 through 628.53, the adjusted carrying value of an equity exposure is:

(1) For the on-balance sheet component of an equity exposure (other than an equity exposure that is classified as available-for-sale), the System institution's carrying value of the exposure;

(2) For the on-balance sheet component of an equity exposure that is classified as available-for-sale, the System institution's carrying value of the exposure less any net unrealized gains on the exposure that are reflected in such carrying value but excluded from the System institution's regulatory capital components;

(3) For the off-balance sheet component of an equity exposure that is not an equity commitment, the effective notional principal amount of the exposure, the size of which is equivalent to a hypothetical on-balance sheet position in the underlying equity instrument that would evidence the same change in fair value (measured in dollars) given a small change in the price of the underlying equity instrument, minus the adjusted carrying value of the on-balance sheet component of the exposure as calculated in paragraph (b)(1) of this section; and

(4) For a commitment to acquire an equity exposure (an equity commitment), the effective notional principal amount of the exposure is multiplied by the following conversion factors (CFs):

(i) Conditional equity commitments with an original maturity of 14 months or less receive a CF of 20 percent.

(ii) Conditional equity commitments with an original maturity of over 14 months receive a CF of 50 percent.

(iii) Unconditional equity commitments receive a CF of 100 percent.

§ 628.52 Simple risk-weight approach (SRWA).

(a) *General.* Under the SRWA, a System institution's total risk-weighted assets for equity exposures equals the sum of the risk-weighted asset amounts for each of the System institution's individual equity exposures (other than equity exposures to an investment fund) as determined under this section and the risk-weighted asset amounts for each of the System institution's individual equity exposures to an investment fund as determined under § 628.53.

(b) *SRWA computation for individual equity exposures.* A System institution must determine the risk-weighted asset amount for an individual equity

exposure (other than an equity exposure to an investment fund) by multiplying the adjusted carrying value of the equity exposure or the effective portion and ineffective portion of a hedge pair (as defined in paragraph (c) of this section) by the lowest applicable risk weight in this paragraph.

(1) *Zero-percent (0%) risk weight equity exposures.* An equity exposure to a sovereign, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, an MDB, and any other entity whose credit exposures receive a 0-percent risk weight under § 628.32 may be assigned a 0-percent risk weight.

(2) *Twenty-percent (20%) risk weight equity exposures.* An equity exposure to a PSE or the Federal Agricultural Mortgage Corporation (Farmer Mac) must be assigned a 20-percent risk weight.

(3) *One hundred-percent (100%) risk weight equity exposures.* The equity exposures set forth in this paragraph (b)(3) must be assigned a 100-percent risk weight:

(i) *Certain equity exposures authorized under § 615.5140(e) of this chapter.* An equity exposure that the FCA has authorized pursuant to § 615.5140(e) for a purpose other than those specified in § 615.5132(a) (for System banks) or § 615.5142 (for associations) of this chapter, unless the equity exposure is assigned a different risk weight under this section.

(ii) *Effective portion of hedge pairs.* The effective portion of a hedge pair.

(iii) *Non-significant equity exposures.* Equity exposures, excluding exposures to an investment firm that would meet the definition of a traditional securitization in § 628.2 were it not for the application of paragraph (8) of that definition and has greater than immaterial leverage, to the extent that aggregate adjusted carrying value of the exposures does not exceed 10 percent of the System institution's total capital.

(A) Equity exposures subject to paragraph (b)(3)(iii) of this section include:

(1) Equity exposures to unconsolidated unincorporated business entities and equity exposures held through consolidated unincorporated business entities, as authorized by subpart J of part 611 of this chapter;

(2) Equity exposures that the FCA has authorized pursuant to § 615.5140(e) for a purpose specified in § 615.5132(a) (for System banks) or § 615.5142 (for associations) of this chapter, unless the

equity exposures are assigned a different risk weight under this section; and

(3) Equity exposures to an unconsolidated rural business investment company and equity exposures held through a consolidated rural business investment company described in 7 U.S.C. 2009cc *et seq.*

(B) To compute the aggregate adjusted carrying value of a System institution's equity exposures for purposes of this section, the System institution may exclude equity exposures described in paragraphs (b)(1), (b)(2), (b)(3)(i), and (b)(3)(ii) of this section, the equity exposure in a hedge pair with the smaller adjusted carrying value, and a proportion of each equity exposure to an investment fund equal to the proportion of the assets of the investment fund that are not equity exposures or that meet the criterion of paragraph (b)(3)(i) of this section. If a System institution does not know the actual holdings of the investment fund, the System institution may calculate the proportion of the assets of the fund that are not equity exposures based on the terms of the prospectus, partnership agreement, or similar contract that defines the fund's permissible investments. If the sum of the investment limits for all exposure classes within the fund exceeds 100 percent, the System institution must assume for purposes of this section that the investment fund invests to the maximum extent possible in equity exposures.

(C) When determining which of a System institution's equity exposures qualify for a 100-percent risk weight under this paragraph, a System institution first must include equity exposures to unconsolidated rural business investment companies or held through consolidated rural business investment companies described in 7 U.S.C. 2009cc *et seq.*; then must include equity exposures that the FCA has authorized pursuant to § 615.5140(e) for a purpose specified in § 615.5132(a) (for System banks) or § 615.5142 (for associations) of this chapter (unless the equity exposures are assigned a different risk weight under this section); then must include equity exposures to unconsolidated unincorporated business entities and equity exposures held through consolidated unincorporated business entities, as authorized by subpart J of part 611 of this chapter; then must include publicly traded equity exposures (including those held indirectly through investment funds); and then must include non-publicly traded equity

exposures (including those held indirectly through investment funds).

(4) *Other equity exposures.* The risk weight for any equity exposure that does not qualify for a risk weight under paragraph (b)(1), paragraph (b)(2), paragraph (b)(3), or paragraph (b)(7) of this section will be determined by the FCA.

(5) [Reserved]

(6) [Reserved]

(7) *Six hundred-percent (600%) risk weight equity exposures.* An equity exposure to an investment firm must be assigned a 600-percent risk weight, provided that the investment firm:

(i) Would meet the definition of a traditional securitization in § 628.2 were it not for the application of paragraph (8) of that definition; and

(ii) Has greater than immaterial leverage.

(c) *Hedge transactions—(1) Hedge pair.* A hedge pair is two equity exposures that form an effective hedge so long as each equity exposure is publicly traded or has a return that is primarily based on a publicly traded equity exposure.

(2) *Effective hedge.* Two equity exposures form an effective hedge if the exposures either have the same remaining maturity or each has a remaining maturity of at least 3 months; the hedge relationship is formally documented in a prospective manner (that is, before the System institution acquires at least one of the equity exposures); the documentation specifies the measure of effectiveness (E) the System institution will use for the hedge relationship throughout the life of the transaction; and the hedge relationship has an E greater than or equal to 0.8. A System institution must measure E at least quarterly and must use one of three alternative measures of E as set forth in this paragraph (c):

(i) Under the dollar-offset method of measuring effectiveness, the System institution must determine the ratio of value change (RVC). The RVC is the ratio of the cumulative sum of the changes in value of one equity exposure to the cumulative sum of the changes in the value of the other equity exposure. If RVC is positive, the hedge is not effective and E equals 0. If RVC is negative and greater than or equal to -1 (that is, less than 0 and greater than or equal to -1), then E equals the absolute value of RVC. If RVC is negative and less than -1 , then E equals 2 plus RVC.

(ii) Under the variability-reduction method of measuring effectiveness:

$$E = 1 - \frac{\sum_{t-1}^T (X_t - X_{t-1})^2}{\sum_{t-1}^T (A_t - A_{t-1})^2}, \text{ where}$$

(A) $X_t = A_t - B_t$,

(B) A_t = the value at time t of one exposure in a hedge pair; and

(C) B_t = the value at time t of the other exposure in a hedge pair.

(iii) Under the regression method of measuring effectiveness, E equals the coefficient of determination of a regression in which the change in value of one exposure in a hedge pair is the dependent variable and the change in value of the other exposure in a hedge pair is the independent variable. However, if the estimated regression coefficient is positive, then E equals 0.

(3) The effective portion of a hedge pair is E multiplied by the greater of the adjusted carrying values of the equity exposures forming a hedge pair.

(4) The ineffective portion of a hedge pair is $(1-E)$ multiplied by the greater of the adjusted carrying values of the equity exposures forming a hedge pair.

§ 628.53 Equity exposures to investment funds.

(a) *Available approaches.* (1) Unless the exposure meets the requirements for an equity exposure under § 628.52(b)(3)(i), a System institution must determine the risk-weighted asset amount of an equity exposure to an investment fund under the full look-through approach described in paragraph (b) of this section, the simple modified look-through approach described in paragraph (c) of this section, or the alternative modified look-through approach described in paragraph (d) of this section, provided, however, that the minimum risk weight that may be assigned to an equity exposure under this section is 20 percent.

(2) The risk-weighted asset amount of an equity exposure to an investment fund that meets the requirements for an equity exposure in § 628.52(b)(3)(i) is its adjusted carrying value.

(3) If an equity exposure to an investment fund is part of a hedge pair and the System institution does not use the full look-through approach, the System institution must use the ineffective portion of the hedge pair as determined under § 628.52(c) as the adjusted carrying value for the equity exposure to the investment fund. The risk-weighted asset amount of the effective portion of the hedge pair is equal to its adjusted carrying value.

(b) *Full look-through approach.* A System institution that is able to calculate a risk-weighted asset amount for its proportional ownership share of each exposure held by the investment fund (as calculated under this subpart as if the proportional ownership share of the adjusted carrying value of each exposure were held directly by the System institution) may set the risk-weighted asset amount of the System institution's exposure to the fund equal to the product of:

(1) The aggregate risk-weighted asset amounts of the exposures held by the fund as if they were held directly by the System institution; and

(2) The System institution's proportional ownership share of the fund.

(c) *Simple modified look-through approach.* Under the simple modified look-through approach, the risk-weighted asset amount for a System institution's equity exposure to an investment fund equals the adjusted carrying value of the equity exposure multiplied by the highest risk weight that applies to any exposure the fund is permitted to hold under the prospectus, partnership agreement, or similar agreement that defines the fund's permissible investments (excluding derivative contracts that are used for hedging rather than speculative purposes and that do not constitute a material portion of the fund's exposures).

(d) *Alternative modified look-through approach.* Under the alternative modified look-through approach, a System institution may assign the adjusted carrying value of an equity exposure to an investment fund on a pro rata basis to different risk weight categories under this subpart based on the investment limits in the fund's prospectus, partnership agreement, or similar contract that defines the fund's permissible investments. The risk-weighted asset amount for the System institution's equity exposure to the investment fund equals the sum of each portion of the adjusted carrying value assigned to an exposure type multiplied by the applicable risk weight under this subpart. If the sum of the investment limits for all exposure types within the fund exceeds 100 percent, the System institution must assume that the fund invests to the maximum extent

permitted under its investment limits in the exposure type with the highest applicable risk weight under this subpart and continues to make investments in order of the exposure type with the next highest applicable risk weight under this subpart until the maximum total investment level is reached. If more than one exposure type applies to an exposure, the System institution must use the highest applicable risk weight. A System institution may exclude derivative contracts held by the fund that are used for hedging rather than for speculative purposes and do not constitute a material portion of the fund's exposures.

§§ 628.54 through 628.60 [Reserved]

Disclosures.

§ 628.61 Purpose and scope.

Sections 628.62 and 628.63 of this subpart establish public disclosure requirements for each System bank related to the capital requirements contained in this part.

§ 628.62 Disclosure requirements.

(a) A System bank must provide timely public disclosures each calendar quarter of the information in the applicable tables in § 628.63. The System bank must make these disclosures in its quarterly and annual reports to shareholders required in part 620 of this chapter. The System bank need not make these disclosures in the format set out in the applicable tables or all in the same location in a report, as long as a summary table specifically indicating the location(s) of all such disclosures is provided. If a significant change occurs, such that the most recent reported amounts are no longer reflective of the System bank's capital adequacy and risk profile, then a brief discussion of this change and its likely impact must be disclosed as soon as practicable thereafter. This disclosure requirement may be satisfied by providing a notice under § 620.15 of this chapter. Qualitative disclosures that typically do not change each quarter (for example, a general summary of the System bank's risk management objectives and policies, reporting system, and definitions) may be disclosed annually after the end of the 4th calendar quarter, provided that any

significant changes are disclosed in the interim.

(b) A System bank must have a formal disclosure policy approved by the board of directors that addresses its approach for determining the disclosures it makes. The policy must address the associated internal controls and disclosure controls and procedures. The board of directors and senior management are responsible for establishing and maintaining an effective internal control structure over financial reporting, including the disclosures required by this subpart, and must ensure that appropriate review of the disclosures takes place. The chief executive officer, the chief financial officer (CFO), and a designated board member must attest that the disclosures meet the requirements of this subpart.

(c) If a System bank concludes that disclosure of specific proprietary or confidential commercial or financial

information that it would otherwise be required to disclose under this section would compromise its position, then the System bank is not required to disclose that specific information pursuant to this section, but must disclose more general information about the subject matter of the requirement, together with the fact that, and the reason why, the specific items of information have not been disclosed.

§ 628.63 Disclosures.

(a) Except as provided in § 628.62, a System bank must make the disclosures described in Tables 1 through 10 of this section. The System bank must make these disclosures publicly available for each of the last 3 years (that is, 12 quarters) or such shorter period beginning on the effective date of this subpart D of this part.

(b) A System bank must publicly disclose each quarter the following:

(1) CET1 capital, AT1 capital, tier 2 capital, tier 1 and total capital ratios, including the regulatory capital elements and all the regulatory adjustments and deductions needed to calculate the numerator of such ratios;

(2) Total risk-weighted assets, including the different regulatory adjustments and deductions needed to calculate total risk-weighted assets;

(3) Regulatory capital ratios during the transition period, including a description of all the regulatory capital elements and all regulatory adjustments and deductions needed to calculate the numerator and denominator of each capital ratio during the transition period; and

(4) A reconciliation of regulatory capital elements as they relate to its balance sheet in any audited consolidated financial statements.

TABLE 1 TO § 628.63—SCOPE OF APPLICATION

Qualitative Disclosures	(a) The name of the top corporate entity in the group to which subpart D of this part applies. ¹ (b) A brief description of the differences in the basis for consolidating entities ² for accounting and regulatory purposes, with a description of those entities: (1) That are fully consolidated; (2) That are deconsolidated and deducted from total capital; (3) For which the total capital requirement is deducted; and (4) That are neither consolidated nor deducted (for example, where the investment in the entity is assigned a risk weight in accordance with this subpart).
Quantitative Disclosures	(c) Any restrictions, or other major impediments, on transfer of funds or total capital within the group. (d) [Reserved] (e) The aggregate amount by which actual total capital is less than the minimum total capital requirement in all subsidiaries, with total capital requirements and the name(s) of the subsidiaries with such deficiencies.

¹ The System bank is the top corporate entity.

² Entities include any subsidiaries authorized by the FCA, including operating subsidiaries, service corporations, and unincorporated business entities.

TABLE 2 TO § 628.63—CAPITAL STRUCTURE

Qualitative Disclosures	(a) Summary information on the terms and conditions of the main features of all regulatory capital instruments.
Quantitative Disclosures	(b) The amount of common equity tier 1 capital, with separate disclosure of: (1) Common cooperative equities a. Statutory minimum borrower stock; b. Other required member stock; c. Allocated equity (stock or surplus); (2) Unallocated retained earnings (URE) and URE equivalents; and (3) Regulatory adjustments and deductions made to common equity tier 1 capital. (c) The amount of tier 1 capital, with separate disclosure of: (1) Additional tier 1 capital elements; and (2) Regulatory adjustments and deductions made to tier 1 capital. (d) The amount of total capital, with separate disclosure of: (1) Common cooperative equities not included in common equity tier 1 capital (2) Tier 2 capital elements, including tier 2 apital instruments; and (3) Regulatory adjustments and deductions made to total capital.

TABLE 3 TO § 628.63—CAPITAL ADEQUACY

Qualitative disclosures	(a) A summary discussion of the System bank's approach to assessing the adequacy of its capital to support current and future activities.
Quantitative disclosures	(b) Risk-weighted assets for: (1) Exposures to sovereign entities; (2) Exposures to certain supranational entities and MDBs; (3) Exposures to GSEs;

TABLE 3 TO § 628.63—CAPITAL ADEQUACY—Continued

	<ul style="list-style-type: none"> (4) Exposures to depository institutions, foreign banks, and credit unions, including OFI exposures that are risk weighted as exposures to U.S. depository institutions and credit unions; (5) Exposures to PSEs; (6) Corporate exposures, including borrower loans (including agricultural and consumer loans) and OFI exposures that are risk weighted as corporate exposures; (7) Residential mortgage exposures; (8) HVCRE exposures; (9) Past due exposures; (10) Exposures to other assets; (11) Loans from System banks to associations; (12) Cleared transactions; (13) Unsettled transactions; (14) Securitization exposures; and (15) Equity exposures. <p>(c) [Reserved]</p> <p>(d) Common equity tier 1, tier 1 and total risk-based capital ratios for the System bank.</p> <p>(e) Total standardized risk-weighted assets.</p>
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TABLE 4 TO § 628.63—CAPITAL CONSERVATION BUFFER

Quantitative Disclosures	<ul style="list-style-type: none"> (a) At least quarterly, the System bank must calculate and publicly disclose the capital conservation buffer as described under § 628.11. (b) At least quarterly, the System bank must calculate and publicly disclose the eligible retained income of the System bank, as described under § 628.11. (c) At least quarterly, the System bank must calculate and publicly disclose any limitations it has on distributions and discretionary bonus payments resulting from the capital conservation buffer framework described under § 628.11, including the maximum payout amount for the quarter.
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(c) *General qualitative disclosure requirement.* For each separate risk area described in Tables 5 through 10, the System bank must describe its risk management objectives and policies, including: Strategies and processes; the structure and organization of the relevant risk management function; the scope and nature of risk reporting and/or measurement systems; policies for hedging and/or mitigating risk and strategies and processes for monitoring the continuing effectiveness of hedges/mitigants.

TABLE 5 TO § 628.63¹—CREDIT RISK: GENERAL DISCLOSURES

Qualitative Disclosures	<ul style="list-style-type: none"> (a) The general qualitative disclosure requirement with respect to credit risk (excluding counterparty credit risk disclosed in accordance with Table 6), including the: <ul style="list-style-type: none"> (1) Policy for determining past due or delinquency status; (2) Policy for placing loans in nonaccrual status; (3) Policy for returning loans to accrual status; (4) Definition of and policy for identifying impaired loans (for financial accounting purposes); (5) Description of the methodology that the System bank uses to estimate its allowance for loan losses, including statistical methods used where applicable; (6) Policy for charging-off uncollectible amounts; and (7) Discussion of the System bank's credit risk management policy.
Quantitative Disclosures	<ul style="list-style-type: none"> (b) Total credit risk exposures and average credit risk exposures, after accounting offsets in accordance with GAAP, without taking into account the effects of credit risk mitigation techniques (for example, collateral and netting not permitted under GAAP), over the period categorized by major types of credit exposure. For example, System banks could use categories similar to that used for financial statement purposes. Such categories might include, for instance: <ul style="list-style-type: none"> (1) Loans, off-balance sheet commitments, and other non-derivative off-balance sheet exposures; (2) Debt securities; and (3) OTC derivatives.² (c) Geographic distribution of exposures, categorized in significant areas by major types of credit exposure.³ (d) Industry or counterparty type distribution of exposures, categorized by major types of credit exposure. (e) By major industry or counterparty type: <ul style="list-style-type: none"> (1) Amount of impaired loans for which there was a related allowance under GAAP; (2) Amount of impaired loans for which there was no related allowance under GAAP; (3) Amount of loans past due 90 days and in nonaccrual status; (4) Amount of loans past due 90 days and still accruing;⁴ (5) The balance in the allowance for loan losses at the end of each period according to GAAP; and (6) Charge-offs during the period. (f) Amount of impaired loans and, if available, the amount of past due loans categorized by significant geographic areas including, if practical, the amounts of allowances related to each geographical area,⁵ further categorized as required by GAAP. (g) Reconciliation of changes in allowances for loan losses.⁶

TABLE 5 TO § 628.63¹—CREDIT RISK: GENERAL DISCLOSURES—Continued

	(h) Remaining contractual maturity delineation (for example, one year or less) of the whole portfolio, categorized by credit exposure.
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¹ Table 5 does not cover equity exposures, which should be reported in Table 9.

² See, for example, ASC Topic 815–10 and 210, as they may be amended from time to time.

³ A System bank can satisfy this requirement by describing the geographic distribution of its loan portfolio by State or other significant geographic division, if any.

⁴ A System bank is encouraged also to provide an analysis of the aging of past-due loans.

⁵ The portion of the general allowance that is not allocated to a geographical area should be disclosed separately.

⁶ The reconciliation should include the following: a description of the allowance; the opening balance of the allowance; charge-offs taken against the allowance during the period; amounts provided (or reversed) for estimated probable loan losses during the period; any other adjustments (for example, exchange rate differences, business combinations, acquisitions and disposals of subsidiaries), including transfers between allowances; and the closing balance of the allowance. Charge-offs and recoveries that have been recorded directly to the income statement should be disclosed separately.

TABLE 6 TO § 628.63—GENERAL DISCLOSURE FOR COUNTERPARTY CREDIT RISK-RELATED EXPOSURES

Qualitative Disclosures	(a) The general qualitative disclosure requirement with respect to OTC derivatives, eligible margin loans, and repo-style transactions, including a discussion of: (1) The methodology used to assign credit limits for counterparty credit exposures; (2) Policies for securing collateral, valuing and managing collateral, and establishing credit reserves; (3) The primary types of collateral taken; and (4) The impact of the amount of collateral the System bank would have to provide given deterioration in the System bank's own creditworthiness.
Quantitative Disclosures	(b) Gross positive fair value of contracts, collateral held (including type, for example, cash, government securities), and net unsecured credit exposure. ¹ A System bank also must disclose the notional value of credit derivative hedges purchased for counterparty credit risk protection and the distribution of current credit exposure by exposure type. ² (c) Notional amount of purchased credit derivatives used for the System bank's own credit portfolio.

¹ Net unsecured credit exposure is the credit exposure after considering both the benefits from legally enforceable netting agreements and collateral arrangements without taking into account haircuts for price volatility, liquidity, etc.

² This may include interest rate derivative contracts, foreign exchange derivative contracts, equity derivative contracts, credit derivatives, commodity or other derivative contracts, repo-style transactions, and eligible margin loans.

TABLE 7 TO § 628.63—CREDIT RISK MITIGATION ^{1 2}

Qualitative Disclosures	(a) The general qualitative disclosure requirement with respect to credit risk mitigation, including: (1) Policies and processes for collateral valuation and management; (2) A description of the main types of collateral taken by the System bank; (3) The main types of guarantors/credit derivative counterparties and their creditworthiness; and (4) Information about (market or credit) risk concentrations with respect to credit risk mitigation.
Quantitative Disclosures	(b) For each separately disclosed credit risk portfolio, the total exposure that is covered by eligible financial collateral, and after the application of haircuts. (c) For each separately disclosed portfolio, the total exposure that is covered by guarantees/credit derivatives and the risk-weighted asset amount associated with that exposure.

¹ At a minimum, a System bank must provide the disclosures in Table 7 in relation to credit risk mitigation that has been recognized for the purposes of reducing capital requirements under this subpart. Where relevant, System banks are encouraged to give further information about mitigants that have not been recognized for that purpose.

² Credit derivatives that are treated, for the purposes of this subpart, as synthetic securitization exposures should be excluded from the credit risk mitigation disclosures and included within those relating to securitization (Table 8).

TABLE 8 TO § 628.63—SECURITIZATION ¹

Qualitative Disclosures	(a) The general qualitative disclosure requirement with respect to a securitization (including synthetic securitizations), including a discussion of: (1) The System bank's objectives for securitizing assets, including the extent to which these activities transfer credit risk of the underlying exposures away from the System bank to other entities and including the type of risks assumed and retained with resecuritization activity; ² (2) The nature of the risks (e.g. liquidity risk) inherent in the securitized assets; (3) The roles played by the System bank in the securitization process ³ and an indication of the extent of the System bank's involvement in each of them; (4) The processes in place to monitor changes in the credit and market risk of securitization exposures including how those processes differ for resecuritization exposures; (5) The System bank's policy for mitigating the credit risk retained through securitization and resecuritization exposures; and (6) The risk-based capital approaches that the System bank follows for its securitization exposures including the type of securitization exposure to which each approach applies. (b) [Reserved] (c) Summary of the System bank's accounting policies for securitization activities, including: (1) Whether the transactions are treated as sales or financings; (2) Recognition of gain-on-sale; (3) Methods and key assumptions applied in valuing retained or purchased interests;
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TABLE 8 TO § 628.63—SECURITIZATION ¹—Continued

Quantitative Disclosures	<p>(4) Changes in methods and key assumptions from the previous period for valuing retained interests and impact of the changes;</p> <p>(5) Treatment of synthetic securitizations;</p> <p>(6) How exposures intended to be securitized are valued and whether they are recorded under subpart D of this part; and</p> <p>(7) Policies for recognizing liabilities on the balance sheet for arrangements that could require the System bank to provide financial support for securitized assets.</p> <p>(d) An explanation of significant changes to any quantitative information since the last reporting period.</p> <p>(e) The total outstanding exposures securitized by the System bank in securitizations that meet the operational criteria provided in § 628.41 (categorized into traditional and synthetic securitizations), by exposure type.⁴</p> <p>(f) For exposures securitized by the System bank in securitizations that meet the operational criteria in § 628.41:</p> <p>(1) Amount of securitized assets that are impaired/past due categorized by exposure type;⁵ and</p> <p>(2) Losses recognized by the System bank during the current period categorized by exposure type.⁶</p> <p>(g) The total amount of outstanding exposures intended to be securitized categorized by exposure type.</p> <p>(h) Aggregate amount of:</p> <p>(1) On-balance sheet securitization exposures retained or purchased categorized by exposure type; and</p> <p>(2) Off-balance sheet securitization exposures categorized by exposure type.</p> <p>(i)(1) Aggregate amount of securitization exposures retained or purchased and the associated capital requirements for these exposures, categorized between securitization and resecuritization exposures, further categorized into a meaningful number of risk weight bands and by risk-based capital approach (e.g., SSFA); and</p> <p>(2) Exposures that have been deducted entirely from tier 1 capital, CEIOs deducted from total capital (as described in § 628.42(a)(1)), and other exposures deducted from total capital should be disclosed separately by exposure type.</p> <p>(j) Summary of current year's securitization activity, including the amount of exposures securitized (by exposure type), and recognized gain or loss on sale by exposure type.</p> <p>(k) Aggregate amount of resecuritization exposures retained or purchased categorized according to:</p> <p>(1) Exposures to which credit risk mitigation is applied and those not applied; and</p> <p>(2) Exposures to guarantors categorized according to guarantor creditworthiness categories or guarantor name.</p>
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¹ A System bank is not authorized to perform every role in a securitization, and nothing in these capital rules authorizes a System bank to engage in activities relating to securitizations that are not otherwise authorized.

² The System bank should describe the structure of resecuritizations in which it participates; this description should be provided for the main categories of resecuritization products in which the System bank is active.

³ Roles in securitizations generally could include originator, investor, servicer, provider of credit enhancement, sponsor, liquidity provider, or swap provider. As noted in footnote 1, however, a System bank is not authorized to perform all of these roles.

⁴ "Exposures securitized" include underlying exposures originated by the System bank, whether generated by them or purchased, and recognized in the balance sheet, from third parties, and third-party exposures included in sponsored transactions. Securitization transactions (including underlying exposures originally on the System bank's balance sheet and underlying exposures acquired by the System bank from third-party entities) in which the originating System bank (as an originating System institution) does not retain any securitization exposure should be shown separately but need only be reported for the year of inception. System banks are required to disclose exposures regardless of whether there is a capital charge under this part.

⁵ Include credit-related other than temporary impairment (OTTI).

⁶ For example, charge-offs/allowances (if the assets remain on the System bank's balance sheet) or credit-related OTTI of interest-only strips and other retained residual interests, as well as recognition of liabilities for probable future financial support required of the System bank with respect to securitized assets.

TABLE 9 TO § 628.63—EQUITIES

Qualitative Disclosures	<p>(a) The general qualitative disclosure requirement with respect to equity risk:</p> <p>(1) Differentiation between holdings on which capital gains are expected and those taken under other objectives including for relationship and strategic reasons; and</p> <p>(2) Discussion of important policies covering the valuation of and accounting for equity. This includes the accounting techniques and valuation methodologies used, including key assumptions and practices affecting valuation as well as significant changes in these practices.</p>
Quantitative Disclosures	<p>(b) Value disclosed on the balance sheet of investments, as well as the fair value of those investments; for securities that are publicly traded, a comparison to publicly quoted share values where the share price is materially different from fair value.</p> <p>(c) The types and nature of investments, including the amount that is:</p> <p>(1) Publicly traded; and</p> <p>(2) Non-publicly traded.</p> <p>(d) The cumulative realized gains (losses) arising from sales and liquidations in the reporting period.</p> <p>(e)(1) Total unrealized gains (losses).¹</p> <p>(2) Total latent revaluation gains (losses).²</p> <p>(3) Any amounts of the above included in tier 1 or tier 2 capital.</p> <p>(f) [Reserved]</p>

¹ Unrealized gains (losses) recognized on the balance sheet but not through earnings.

² Unrealized gains (losses) not recognized either on the balance sheet or through earnings.

TABLE 10 TO § 628.63—INTEREST RATE RISK FOR NON-TRADING ACTIVITIES

Qualitative disclosures	(a) The general qualitative disclosure requirement, including the nature of interest rate risk for non-trading activities and key assumptions, including assumptions regarding loan prepayments and behavior of non-maturity deposits, and frequency of measurement of interest rate risk for non-trading activities.
Quantitative disclosures	(b) The increase (decline) in earnings or economic value (or relevant measure used by management) for upward and downward rate shocks according to management's method for measuring interest rate risk for non-trading activities, categorized by currency (as appropriate).

§§ 628.64 through 628.99 [Reserved]

(1) [Reserved]

Subpart E—[Reserved]

(2) Beginning January 1, 2016 through December 31, 2018 a System

Subpart F—[Reserved]

institution's maximum payout ratio must be determined as set forth in Table 1 to § 628.300.

Subpart G—Transition Provisions

§ 628.300 Transitions.

(a) *Capital conservation buffer.*

TABLE 1 TO § 628.300

Transition period	Capital conservation buffer	Maximum payout ratio (as a percentage of eligible retained income)
Calendar year 2016	> 0.625 percent	No limitation.
	≤ 0.625 percent, and > 0.469 percent	60 percent.
	≤ 0.469 percent, and > 0.313 percent	40 percent.
	≤ 0.313 percent, and > 0.156 percent	20 percent.
	≤ 0.156 percent	0 percent.
Calendar year 2017	> 1.25 percent	No limitation.
	≤ 1.25 percent, and > 0.938 percent	60 percent.
	≤ 0.938 percent, and > 0.625 percent	40 percent.
	≤ 0.625 percent, and > 0.313 percent	20 percent.
	≤ 0.313 percent	0 percent.
Calendar year 2018	> 1.875 percent	No limitation.
	≤ 1.875 percent, and > 1.406 percent	60 percent.
	≤ 1.406 percent, and > 0.938 percent	40 percent.
	≤ 0.938 percent, and > 0.469 percent	20 percent.
	≤ 0.469 percent	0 percent.

(b) through (e) [Reserved]

§ 628.301 Initial compliance and reporting requirements.

(a) A System institution that fails to satisfy one or more of its minimum applicable CET1, AT1, tier 1, tier 2, or total capital ratios at the end of the quarter in which these regulations become effective shall report its initial noncompliance to the FCA within 20 days following such quarterend and shall also submit a capital restoration plan for achieving and maintaining the standards, demonstrating appropriate annual progress toward meeting the goal, to the FCA within 60 days following such quarterend. If the capital restoration plan is not approved by the FCA, the FCA will inform the institution of the reasons for disapproval, and the institution shall submit a revised capital restoration plan within the time specified by the FCA.

(b) *Approval of compliance plans.* In determining whether to approve a

capital restoration plan submitted under this section, the FCA shall consider the following factors, as applicable:

(1) The conditions or circumstances leading to the institution's falling below minimum levels, the exigency of those circumstances, and whether or not they were caused by actions of the institution or were beyond the institution's control;

(2) The overall condition, management strength, and future prospects of the institution and, if applicable, affiliated System institutions;

(3) The institution's capital, adverse assets (including nonaccrual and nonperforming loans), ALL, and other ratios compared to the ratios of its peers or industry norms;

(4) How far an institution's ratios are below the minimum requirements;

(5) The estimated rate at which the institution can reasonably be expected to generate additional earnings;

(6) The effect of the business changes required to increase capital;

(7) The institution's previous compliance practices, as appropriate;

(8) The views of the institution's directors and senior management regarding the plan; and

(9) Any other facts or circumstances that the FCA deems relevant.

(c) An institution shall be deemed to be in compliance with the regulatory capital requirements of this subpart if it is in compliance with a capital restoration plan that is approved by the FCA within 180 days following the end of the quarter in which these regulations become effective.

Dated: August 8, 2014.

Dale L. Aultman,

Secretary, Farm Credit Administration Board.

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