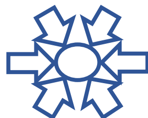

Financial Services Management

Credit-Risk Capital Rewrite

Cite

FDIC, FRB, OCC, Notice of Proposed Rulemaking, Regulatory capital rule: Amendments applicable to large banking organizations and to banking organizations with significant trading activity

Recommended Distribution

CFO, Treasurer, Asset/Liability Management, Credit Administration, Policy, Corporate Development, Legal, Government Relations

Website

https://www.fdic.gov/news/board-matters/2023/2023-07-27-notice-dis-a-fr.pdf

Impact Assessment

- The interplay of the "higher-of" SA approach for credit risk with the proposals for market and operational risk will require covered banks to compute complex tradeoffs between rules that may more accurately reflect lower credit risk and some that hiked credit risk charges in the still-uncertain context of other capital rules, the stress capital buffer, and non-capital regulations still in formulation.
- Although covered banks will surely hold more capital than most do now, improving resilience, unintended consequences seem likely as banks determine the best path for capital optimization.
- Banks with relatively traditional business models may find these trade-offs particularly challenging as the proposed risk weights for retail and corporate assets are often lower than current standardized charges. Mid-sized regional banks forced into this new framework are thus likely to look for ways to add risk in certain credit categories where new rules are higher to make credit risk ratios work ahead of the still more complex considerations of the proposed output floor.
- Tougher RWAs for bank exposures may lead banks to seek other counterparties, increasing the role of insurers, hedge funds, PEs, and other "shadow" banks. However, banking-sector contagion risk could drop.
- New SA charges would hike capital costs for complex payment, clearing, and settlement transactions as well as repos and banking-book trading activities. Repo markets may be particularly affected, perhaps reducing liquidity and resilience.
- Lower RWAs for certain credit risks combined with other, costly requirements may lead the largest banks to abandon certain capital-market and wholesale-finance activities, ceding these to nonbank financial institutions and increasing concentration within traditional financial intermediation.
- Mortgage-related risk receives better treatment than current rules but is less advantageous than that Basel proposed. MI no longer counts and some HLTV loans may not be capital-efficient, reducing credit availability for under-served markets.
- Higher RWAs for defaulted loans or those in danger of default may well reflect risk, but also increase capital procyclicality. The potential for sharp capital hikes as bank conditions weaken might also prove procyclical or threaten financial stability if the number of troubled institutions is large and the result of declining macroeconomic or financial-market conditions.

Overview

In this report, we proceed from our assessment of the proposed regulatory capital framework[1] to an analysis of the rules governing credit risk. In addition to eliminating the

[1] See **CAPITAL230**, *Financial Services Management*, August 1, 2023.

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advanced approach,[2] the proposal imposes higher standards for some assets than under the old standardized approach (SA)[3] via new "expanded" requirements. As detailed here, many expanded risk weightings are higher than current requirements either due to specific risk-weighted assessments (RWAs) or definitions and additional restrictions. This contributes to the added capital costs identified by the banking agencies in their impact assessment, suggesting that lower risk weightings in the expanded approach reflected the reduced risks described in the proposal for other assets and will ultimately have little bearing on regulatory-capital requirements and thus on the overall ability of banks to expand into lower-risk areas and compete more effectively with nonbanks and foreign banks. Big banks forced to abandon certain activities may expand others receiving capital discounts in the new rules, increasing their footprint in traditional banking in ways that may increase industry consolidation.

Impact

The impact of these RWA changes will vary based on each covered bank's business model and prevailing economic conditions. Category I and II banks will see the least impact if their internal models had previously reflected the higher risks now judged to be present in the expanded SA's weightings, but their ability to capture lower SAs will be limited by the manner in which the complex trade-offs mandated by the sum total of the new rules works out for each business model under applicable macroeconomic and financial-market circumstances.

Category III and IV banks will see lower credit-risk related capital in some areas, but their capital costs may still rise due to offsetting, higher SAs and all these trade-offs. In general, application not only of higher SAs, but also of the new market- and operational-risk rules will offset any lower credit-risk capital requirements. As noted in our prior report, category III and IV banks will also be most adversely affected by incorporating AOCI calculations in their capital requirements.

Within the parameters of all these complex trade-offs, banks will try to optimize capital by taking maximum advantage of reduced credit-risk weightings. Business models could thus be materially affected. Further, defaulted loans (see below) would also force higher capital for banks that may have long believed that added loan-loss reserves sufficed for specific obligations and did not look more generally at the credit-risk market as would now be required.

The new treatment of defaulted loans could also increase the capital rule's procyclicality even as it increases the capital cushion ahead of possible loan losses. Banks could also face operational and systems challenges managing not just individual exposures, but also the interconnection of these exposures with others of the obligor and any indirect interconnections of the obligor to other borrowers or counterparties.

As detailed below, the new, expanded RWAs range in terms of the extent to which they are higher or lower than current rules as well as the underlying Basel standards.[4] As a result, asset-class implications will vary even as specific results are then factored into the broader framework and its overall capital hike compared to that now posted by categories I, II, III, and IV banks. As detailed below, retail exposures deemed low-risk get a significant break from the current 100 percent weighting even though higher-risk exposures now also eligible for 100 percent may come under slightly higher requirements. This is a significant boon to credit and charge-card companies in terms of capital

[2] See **CAPITAL201**, *Financial Services Management*, July 19, 2013.

[3] See **CAPITAL200**, *Financial Services Management,* July 15, 2013.

[4] See **CAPITAL221**, *Financial Services Management,* January 2, 2018.

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requirements, but a benefit likely more than offset by imposition of the operational-risk capital charge.[5] Retail loans also receive a capital-weight reduction, perhaps encouraging more small-balance consumer lending. However, a new "granularity" requirement limits the benefit of this for all but the largest wealth-management focused banking organizations.

The proposal also reduces the risk weighting for investment-grade companies encompassed in new requirements for publicly-traded securities found throughout the new approach. As with retail exposures, higher-risk corporates would get a somewhat higher-charge than currently applied, but all non-investment-grade or unlisted companies would get the 100 percent weighting that now applies. The sum total of these changes is to make large C&I lending somewhat more capital-efficient and to give nonbanks that are eligible guarantors (see below) a fighting chance against bank guarantors. Banks are among the entities where RWAs go up – the current twenty percent RWA is doubled for the lowest-risk banks and then slides up to 150 percent. The capital advantage for corporates is counter to the agencies' goal of limiting nonbank financial intermediation, but capturing weaker-bank risk also reduces the likelihood of contagion risk within the banking sector.

Also as detailed below, the new approach is more stringent when it comes to commercial real estate (CRE), especially that dependent on cash flows such as hotels and shopping centers. Acquisition, development, and construction (ADC) loans also get a considerably higher RWA, with these standards likely to fall most heavily on the category IV banks for which CRE is often a significant asset concentration. Historically, CRE credit availability has been a boom-bust business; going forward, it may be still more difficult for borrowers to find credit other than from small banks outside the new rules, some of which may have difficulty backing large and/or urban projects.

Although questions about many sections in the NPR suggest that the agencies think changes are relatively minor, those posed on the mortgage standards clearly recognize how controversial these have proved to be. Indeed, the agencies have left themselves clear out for changes at least when it comes to affordable-housing or other lower-income related loans with the questions noted below. Much of this is because mortgage lenders had hoped the U.S. would adopt Basel's standardized twenty percent weighting for all but the highest-LTV mortgages, which come under only a seventy percent weighting. The global rules also recognize LTV offsets such as private mortgage insurance (MI). The U.S. approach ends the recognition now afforded mortgages with LTVs over eighty percent that are considered prudently-underwritten due only to MI, thus avoiding the maximum 100 percent weighting. However, weightings in the proposal are generally the same or more favorable for all loans except those with LTVs over eighty even where MI is obtained. A major concern for category III and IV banks in the rules is the tough treatment for mortgage servicing assets, but this is separate from the new weightings.

What's Next

The capital standards were approved on a 4-2 vote by the Federal Reserve Board, a 3-2 vote by the FDIC board, and the Acting Comptroller of the Currency on July 27. Comment is due November 30. The new rules will be phased in beginning on July 1, 2025 until June 30, 2028. A similar three-year phase-in is detailed for category III and IV banks with regard to AOCI recognition.

[5] See forthcoming *FedFin report*.

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In addition to these standards, the agencies will issue new disclosure requirements. They will also modify rules affected by the new approach to regulatory capital, including via the GSIB modification proposed in concert with this proposal.[6] Other affected rules revised by this proposal govern TLAC[7] and single-counterparty exposures, eliminating reliance on internal models.[8] The Board in 2019 also issued a long-delayed proposal governing the capital of depository institution holding companies with significant insurance operations.[9] Any final rule will reflect the new capital regime, with no time indicated for how long it may take the Board to do so once these rules are finalized. Thus, as has long been the case, these insurance-focused companies remain subject to significant uncertainty about parent-company capital standards but avert the top-down, bank-focused approach the Board once favored.

Analysis

The agencies reiterate their expectation that banks will conduct due diligence on all credit-risk exposures and hold capital commensurate with risk regardless of applicable regulatory risk weighting. However, banks could apparently leave capital as is where not expressly altered if they add loan-loss reserves and/or receive additional collateral.

A. New Framework

As noted, the NPR would eliminate the advanced approach, replacing this with "expanded" standardized weights. Definitions in the current rule are largely the same as the NPR other than where noted below for asset classes. Certain current weightings (e.g., zero for sovereigns, twenty percent for GSE debt) are retained. A currency mismatch RWA adjustment would be required for residential mortgages and retail exposures where applicable. The mismatch multiplier would be 1.5 times with a limit of 150 percent.

B. Defaulted Exposures

This definition has been broadened compared to the current rule to encompass any defaulted credit exposure (i.e., where there is risk related to the obligor that is not counterparty risk) that is not an exposure to a sovereign, real-estate exposure (see below), or policy loan (i.e., an insurance company loan to a policyholder). Certain derivatives, cleared transactions, and margin loans are also excluded in this section for treatment elsewhere in the NPR.

Banks would be required to treat all obligations of a borrower that has defaulted on any exposure that is not a retail exposure as defaulted. The proposal also requires defaulted-loan treatment even if the bank's own exposures to a borrower are current if the bank knows that the non-retail borrower has failed to honor any credit obligations, or if other risk-monitoring concerns are evident.

Retail exposures are to be considered defaulted if they are ninety days past-due, are nonaccrual, or have led to a partial charge-off or similar action (including bankruptcy filing by the borrower).

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[6] See forthcoming *FedFin Report.*

[7] See **TLAC6**, *Financial Services Management,* December 21, 2016.

[8] See **CONCENTRATION11**, *Financial Services Management*, June 25, 2018.

[9] See **INSURANCE60**, *Financial Services Management,* September 17, 2019.

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Loans may not be considered current until the bank has again determined a reasonable ability to repay or has entered into a distressed debt restructuring that meets regulatory criteria. Non-default status may also be granted if the obligor has become investment or "speculative" grade, but the latter criterion is revised only to cover situations where risk derives from general economic circumstance, not the obligor's creditworthiness.

Defaulted exposures (including non-defaulted ones on the bank's balance sheet) would receive a 150 percent risk weight; this weighting may be reduced if there is eligible credit risk mitigation (see below).

C. GSEs

GSE exposures that are not equity, securitizations, or subordinated debt would get a twenty percent weighting; this differs from the current rule by clarifying that GSE common stock is equity and preferred stock is either equity or subordinated debt. These exposures are thus covered by otherwise-applicable equity or securitization treatment, with subordinated debt issued by a GSE receiving a 150 percent RWA. Fannie Mae and Freddie Mac common stock would receive a 250 percent weighting, but equity and FHLB and Farmer Mac equity would retain their twenty percent weighting.

D. Depository Institutions, Foreign Banks, and Credit Unions

The proposal says that its approach is "consistent" with current rules but is in fact substantively different. Current rules generally treat all U.S. banks as twenty percent RWAs, with graduated treatment for foreign banks. Under the new rules, U.S. domiciled banks, foreign banks, and credit unions would be divided into three categories based on capitalization and investment/speculative-grade ratings. The best RWA is forty percent for entities with investment-grade ratings that meet applicable minimum capital ratios as evident in public disclosures and are not otherwise restricted with regard to capital distributions and discretionary-bonus payments. U.S. banks would need also to be well-capitalized as measured by the banking agencies. Small banks opting into the community-bank leverage ratio that are investment-grade would also get this favorable weighting. Weightings rise as capitalization and rating declines, with the riskiest banks and credit unions subject to a 150 percent weighting. Foreign banks eligible for the two highest weightings would need to be governed by home-country standards equivalent to those mandated by the Basel committee. Entities that meet top two-grade requirements would still fall into the highest-risk category if an external auditor has expressed concern about going-concern viability. Foreign banks also could not have a risk weight lower than that of their home country except in certain circumstances.

As in the current rules, BHCs, SLHCs, and securities companies are treated as corporate exposures, as are insurance companies.

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E. Subordinated Debt

This includes instruments such as GSIB debt, TLAC long-term debt not otherwise deducted from regulatory capital under other provisions in the rule[10], and certain other instruments issued by financial institutions. Secured subordinated debt is also covered by the new RWA because the agencies doubt that collateral is a meaningful risk mitigant for these instruments.

Sub-debt would generally get a 150 percent risk weighting.

F. Real-Estate Exposures

The discussion below addresses key considerations in this arena. RWAs for non-defaulted construction-related loans set by law are not changed.[11] Additional risk weightings apply to loans where repayment is dependent on cash flow.

1. Residential Real Estate

RWAs for non-defaulted first-lien mortgages are first derived from LTV ratios combined if the lender holds both a first and second lien. LTVs are calculated by current loan amount and property value at origination validated by appraisal and valuation processes detailed in the NPR. RWAs would range from forty percent for loans below a fifty percent ratio to ninety percent for loans above one hundred percent or that otherwise do not meet the rule's prudential standards. These generally require demonstration of ability to repay based on the loan's designation as a qualified mortgage (QM) or certain other criteria.[12] Eligible loans must either be owner-occupied or owner-rented, ending favorable RWAs for investment properties and, perhaps, second homes).

Unlike the current rules, RWAs would not adjust if a high-LTV loan is backed by private mortgage insurance (MI). This is done because the agencies make it clear that they do not trust MI loss-absorbing capacity. Junior-lien HELOCs and other second mortgages would receive a 100 percent weighting.

2. Commercial Real Estate

CRE properties in this category must be largely completed and non-defaulted, with the bank holding an enforceable first-security legal-claim priority. Prudential and ability-to-repay standards also apply, with RWAs varying from seventy percent for CRE loans with an LTV below sixty percent to 110 percent for the highest-LTV loans and those that do not meet safety-and-soundness standards. LTV calculation methodology is detailed, as is eligible collateral that could be included in the LTV calculation.

3. Defaulted Exposures

Residential-mortgage loans are evaluated for default status by exposure; those for commercial real estate by obligor. Non-cash flow mortgages in default receive a 100 percent RWA, the same as that for higher-risk loans that are not in default; FHA- or VA-guaranteed loans receive a twenty percent RWA in default; again, this is the same as the current rule. All other real-estate exposures in default receive a 150 weight.

4. Additional Exposures

[10] See **CAPITAL230**, *Financial Services Management*, August 1, 2023.

[11] See **CAPITAL200**, *Financial Services Management*, July 15, 2013.

[12] See *Client Report* **MORTGAGE110**, January 10, 2013.

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The NPR also includes extensive discussion of other real-estate exposures where RWAs are not set by law, with ADC loans now receiving a 150 percent RWA compared to the current 100.

G. Retail Exposures

RWAs for this category would fall over a wider range than the current, largely-uniform 100 percent. Assets in this category continuing to be those to natural persons and small/medium businesses, but the scope of the new definition is tighter to exclude certain real-estate related exposures (with these coming under terms noted above). Individual exposures or those to a single obligor could not be more than $1 million, with a granularity limit of 0.2 percent to ensure portfolio diversification.

1. Transaction Exposures

These are credit facilities that are to be repaid in full at the end of each scheduled repayment period for the past twelve months or overdraft facilities without drawdowns in the previous year. These transaction exposures receive a 55 RWA.

2. Other Retail Exposures

Regulatory retail exposures (i.e., those that fall under the definition and limits above) would receive an 85 percent RWA; additional retail exposures would have a 110 percent weight.

H. Corporate Exposures

As in the current rule, any exposure not defined above would be considered corporate. Real-estate loans to corporations are still considered real estate. Key provisions include:

- a 65 percent weight for investment-grade entities with outstanding public securities or a controlling parent company with such securities;
- two or four percent RWAs for certain exposures to central counterparties;
- a 130 percent weight for project exposures that are not a project finance operational-phase exposure;
- a 150 percent RWA for subordinated debt or certain other debt obligations unless deductions are allowed (see above); and
- a 100 percent weight for all other corporate exposures.

I. Off-Balance Sheet Assets

As in the current rules, the proposal includes a credit-conversion factor (CCF) to set RWAs for commitments such as stand-by letters of credit or guarantees. Also as under current rules, certain CCFs – e.g., guarantees – are set at 100 percent, essentially mooting the difference of holding an asset or backing it for another entity. Lower CCFs generally require unconditional cancellation rights, but new averaging procedures are proposed for products such as credit and charge cards. The CCFs for commitments would be simplified to eliminate maturity adjustments and impose a forty percent RWA on commitments without unconditional cancellation rights (which would have a ten percent CCF).

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone: (202) 589-0880
E-mail: info@fedfin.com Website: www.fedfin.com

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J. Derivatives

All covered banks would come under the SA-CCR, eliminating internal-model options within it. Numerous "technical" changes are also made to these requirements.

K. Credit Risk Mitigation (CRM)

Consistent with the end of internal models, the proposal related to collateral eliminates their use as well as "double-default" provisions in current rules that enhance collateral and certain credit derivatives' value as a risk-based capital offset, also limiting use of end-to-default derivatives and most of these instruments that do not consider restructuring as default. For collateral eligibility, corporate debt must be issued by an obligor or obligor controlling parent with publicly traded securities. Collateral also comes under additional restrictions, including new haircuts for certain eligible margin loans and repos with unregulated financial institutions (here carefully defined and expressly including hedge and private-equity funds). A significant market-price haircut designed in part to reflect MMF liquidity risk is also proposed. Cross-product netting would no longer be allowed.

Substitution – i.e., swapping the RWA for the CRM provider for that of the asset – remains permissible for guarantees. All eligible guarantees would need to be issued by eligible guarantors. These are not defined in the proposal, referencing back to current rules. This presages provisions in the NPR by, for example, barring monoline credit insurers from eligible-guarantor status and requiring them either to issue public debt or have a parent company that does so. Sovereign and GSE entities are automatically eligible, as are banks apparently without regard to how they score on the grading system described above.

L. Request for Comment

Strategic issues on which views are sought include:

- if due-diligence standards should be directly incorporated in the capital rule, specifying additional risk weights as credit quality deteriorates;
- the extent to which the defaulted-loan treatment meets current bank practice and any new operational challenges should it not do so. Questions are also posed about the extent to which banks are able to learn of a retail-borrower's bankruptcy;
- alternatives to the proposed capital treatment for banks that might reduce procyclicality. Comment is also sought on other ways to identify risk at regulated banks and credit unions and the benefits of returning to the current approach to country-risk classification for foreign banks;
- how best to define cash floor for real-estate exposures;
- the proposed capital treatment of second homes and residential real estate where cash flow is dependent on overnight or similar short-stay rentals (with the agencies suggesting that these obligations might best be treated as CRE);
- whether the RWAs for mortgages adversely affect affordable housing and/or creditworthy LMI/under-served borrowers and, if so, if this could be corrected via a preferential RWA (e.g., fifty percent) for loans originated as part of CRA or similar programs that incorporate risk-mitigation features;
- whether to retain the current treatment for prudent mortgages (likely excluding the current concessions for MI-backed loans);
- potential market effects of the new residential and commercial real estate RWA;
- other or better ways to ensure retail-portfolio diversification and the operational burden associated with the proposal;
- the retail transaction-account definition's value in predicting credit risk;
- an alternative to the 100 percent weighting for companies that are not publicly-traded that recognizes those which are highly regulated (e.g., open-end funds, mutual insurance companies, pension funds, and registered investment

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companies). Why these firms are cited is not made clear. Reduced weights for smaller corporates are also noted;

- the definition of nonbanks for purposes of steep collateral haircuts, with the agencies considering expanding this to all counterparties other than CCPs; and
- implications of the new collateral standards for repo and other transaction migration outside the banking system.

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone: (202) 589-0880
E-mail: info@fedfin.com Website: www.fedfin.com

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